WHICH?

TAX SAVING GUIDE 2001

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The *Which? Tax Saving Guide 2001* explains everything you need to know about income tax, National Insurance, capital gains tax and inheritance tax. We also give details of the latest budget changes, such as the introduction of the new children's tax credit (not to be confused with the working families tax credit).

If you're eligible for this new allowance and haven't claimed it yet, contact your tax office or the special Revenue helpline – see p31 for more details.

You may feel you lost out in the 2000-2001 tax year since it was the first one in which most taxpayers couldn't claim the married couple's allowance, the additional personal allowance, tax relief on maintenance payments and tax relief on mortgages.

If you've missed claiming any of your allowances in the past, however, it's not too late – you can claim a refund as far back as the 1995-1996 tax year. To find out more, see p32.

Kirsten Edwards

Kirsten Edwards
Editor

WHICH?
TAX SAVING
GUIDE 2001

Editor
Kirsten Edwards

Design
Mark Massey

Production Editor
Barbara White

Illustrations
Kevin Evans

Researchers
Teresa Fritz
Becky Hall
Tim Young

Photography
John Trenholm
(except p4 South West News and p23 Post Studios Photographic)

Published by Which? Ltd, the trading subsidiary of Consumers' Association, a registered charity, 2 Marylebone Road, London NW1 4DF

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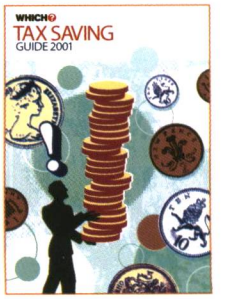
Printed by
St Ives (Caerphilly) Ltd



WHY YOU NEED THIS GUIDE

Many of us pay too much tax on our income and savings, yet don't do anything about it. Our guide tells you whether you could make a saving.

If you are a taxpayer, your tax bill is probably one of the biggest bills you'll get all year. The Inland Revenue wants taxpayers to pay the tax they owe – no more and no less. But to do this, and to be sure you still pay the correct amount, you have to know what you pay tax on, how much you have to pay, and when to pay it. This is where the *Which? Tax Saving Guide* comes in. It explains the basics of income tax, National Insurance, inheritance tax and capital gains tax. It covers tax on savings and investments and on property you might let, and explains the recent changes in the pension world. It also looks at tax for employed and self-employed people. As always, we've included relevant information from the last budget.

Every year we hear from *Which?* members telling us how they successfully challenged their tax bills and received refunds – often because of help from the guide. If the guide has helped you, or if there is something you'd like to see in the guide, please let us know. Write to department TF, *Which?*, PO Box 44, Hertford X SG14 1SH, or e-mail tax@which.net.

TAX FACTS

Here are the basic tax facts and figures that apply after this year's budget, and some changes or proposals.

Tax rates

Tax on non-savings and non-dividend income earned in 2001-2002 is charged at three rates: 10 per cent starting rate, 22 per cent basic, and 40 per cent higher rate. The table on p4 shows the bands of income on which each rate is levied.

Allowances

Everyone gets a personal tax allowance. This is the amount you can earn before you start to pay tax. People aged 65 or over may get a higher amount, known as age-related allowance – see p17.

Cars

If you're about to buy a company car, you should check how environmentally friendly it is. The new tax regime for company cars comes in from April 2002. The chapter on fringe benefits (p8) tells you more.

Road tax

From 1 July 2001, the £55 lower rate of road tax is extended to cars with engines up to 1549cc.

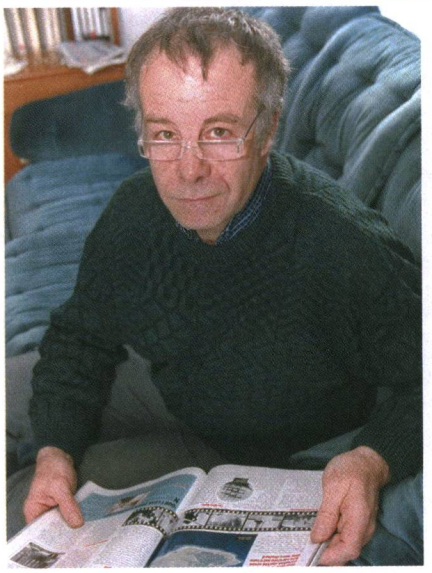
Self-employment

Some new incentives for small businesses and changes to simplify the VAT regime were introduced in the budget. However, newly self-employed people who don't tell the Revenue about their change of status within three months of setting up will be liable to a new £100 fine.

National Insurance

The government's promise to bring tax and National Insurance into line for employees finally takes effect from April 2001. The amount ▶

Confusion over 20-year rule



Every year in the *Which? Tax Saving Guide* we mention the little-known '20-year' rule. This rule states that, if you pay too much tax because of a mistake by the Inland Revenue or any other government department, you can 'claim a repayment for any year which was affected by the mistake going back up to 20 years'.

However, we regularly hear from *Which?* members who have approached their tax offices about this rule, only to be told that no such rule exists.

This is what happened to Derek Morley when he tried to claim a tax refund for a mistake he thinks was made by the Revenue as far back as the early 1980s. His tax office wasn't aware of the 20-year rule, so Derek wrote to us for clarification.

The relevant text is clearly contained in the Inland Revenue's own Code of Practice 1, *Mistakes by the Inland Revenue*. However, it is tucked away under the heading 'Late claims,' which is why it's not obvious to everyone. Just to be sure, we checked with the Inland Revenue's main office at Somerset House that the rule still exists – and it definitely does. Armed with this information, Derek is now renewing his claim for overpaid tax.

ALLOWANCES AND TAX BANDS

	2000-2001 tax year (£)	2001-2002 tax year (£)
Personal allowance		
Basic	4,385	4,535
Age-related: if you're 65 to 74	5,790	5,990
Higher age-related: if you're 75 or over	6,050	6,260
Married couple's allowance[1,2]		
Minimum amount	2,000	2,070
Either spouse born before 6 April 1935	5,185	5,365
Higher age-related: either spouse 75 or over	5,255	5,435
Children's tax credit[1]		5,200
Tax bands		
Starting rate (10%)	up to 1,520	up to 1,880
Basic rate (22%)	1,521 to 28,400	1,881 to 29,400
Higher rate (40%)	over 28,400	over 29,400

1 Relief is restricted to 10 per cent
2 Allowances abolished from 6 April 2000. However, married couple's allowance remains for married couples where one or both parties was born before 6 April 1935, or where one person born before 6 April 1935 marries on or after 6 April 2000

you can earn before paying National Insurance is now the same as the amount you can earn before paying income tax – see p15.

Tax credits

Some rates increased for new claims from June 2001, including the amount you can claim for childcare – see p20.

Tax for older people

Basic state pension rises to £72.50 a week for single pensioners from April 2001 and to £115.90 a week for couples. The minimum income guarantee rises to £92.15 a week for single pensioners and £140.55 a week for couples. From April 2003 a new pension credit will be introduced. As well as guaranteeing a minimum income, the credit will reward modest saving for retirement. However, where income exceeds a set minimum, the credit is reduced by 40p for each £1 of the excess.

Savings and investments

For 2001-2002, tax on savings income is charged at 10 per cent where total taxable income is less than £1,880, 20 per cent between £1,881 and £29,400, and 40 per cent on amounts above £29,400. Tax on savings income is usually deducted at source at the rate of 20 per cent. If you are a non-taxpayer or starting-rate taxpayer, you will have to reclaim all or part of the tax already paid.

Non-taxpayers, starting-rate and basic-rate taxpayers pay 10 per cent tax on dividend income, higher-rate taxpayers pay 32.5 per cent. Isa limit levels stay unchanged until April 2006 – see p22.

Capital gains

In 2001-2002, you can make capital gains of £7,500 before paying capital gains tax. Above this, starting-rate taxpayers pay capital gains tax at 10 per cent, basic-rate taxpayers at 20 per cent, and higher-rate taxpayers at 40 per cent – see p24. Business taper relief is extended to employee shares of non-trading companies.

You and your family

The new children's tax credit comes in from April 2001 and will be worth up to £520 a year. From April 2002 the children's tax credit will be doubled in the year you have a baby. This higher amount of CTC will be paid for the child's first year.

Inheritance tax

The threshold for inheritance tax now applies to estates above £242,000. The rate payable on death is still 40 per cent – see p33.

Giving to charity

All gifts to charity now go through the Gift Aid scheme. Deeds of covenants taken out on or before 5 April 2000 can run to the end of the original term. There is no minimum on Gift Aid donations so all donations will qualify for basic-rate tax relief. Higher-rate taxpayers can claim 18 per cent tax relief (the difference between basic- and higher-rate tax) through their tax office.

Donations through Gift Aid are not suitable for non- or starting-rate taxpayers as you will have to repay part or all the tax reclaimed by the charity.

If your employer runs a payroll-giving scheme, you can pay any regular amount from your salary. Tax relief at your top rate is given by taking the donations to registered charities before tax on your pay is worked out. The government will add 10 per cent to any gift made through payroll giving until 5 April 2003.

PAYE INCOME

Most employers deduct tax from your salary before they pay it, under the Pay As You Earn (PAYE) scheme. Income from a company pension is also usually taxed under PAYE.

Even so, it's still possible to be paying the wrong amount of tax. Always check your PAYE code and that you're claiming the right allowances.

PAYE CODES

The Revenue gives employers a PAYE code for each employee (or pensioner), which tells them how much tax to deduct. Your coding notice, together with your payslip or pension notification, is the key to ensuring that you pay the right amount of tax.

Most PAYE codes consist of a letter (see right) and a number. The number tells your employer how much tax-free pay you're allowed in each tax year. The letter means that employers can alter code numbers for some employees automatically, in line with budget changes.

The number is arrived at by working out the allowances and reliefs to which you are entitled. An amount is taken off for taxable benefits or other income you get, such as a company car or state pension.

The final result is the amount of tax-free income to which you are entitled in the tax year. This is converted to your PAYE code by removing the last digit and adding the relevant code letter.

To work back from your code to your tax-free pay, just put a 9 on the end of the number (the knocked-off figure is always assumed to be 9). So if, say, your code is 453L, you can earn one-twelfth of £4,539 (£378) free of tax each month.

If your deductions, such as fringe benefits, exceed your allowances and reliefs, then your code begins with a K. The excess over your allowances (shown by the number part of your code) is added to your pay for tax purposes.

YOUR CODING NOTICE

A coding notice gives details of how your PAYE code is worked out. You won't necessarily get one, especially if your tax affairs are straightforward. The Revenue sends out most notices in January or February to apply from the start of the next tax year (6 April).

The Revenue may also send you a notice if you query your code, if your circumstances change, or if there is a change in tax rules.

Allowances

We've shown an example coding notice overleaf. Entries on the left under 'Your tax allowances' (such as your personal allowance) increase the amount of tax-free pay to which you're entitled.

If you are 65 or over, you may see an estimate of your total annual income described as Estimated Income. This is used to calculate age-related allowances (which depend on your income – see p16).

Tax-allowable payments that qualify for relief may also be shown. The figure on the coding notice is the amount your tax office expects you to pay in the coming tax year (for example, if pension premiums are given, it will assume you're paying the same as last year).

Possible entries include:

- payments for allowable expenses incurred in your job, and professional subscriptions that are essential for your work
- payments to personal pension or stakeholder plans (or old-style retirement annuity contracts) and payments to free-standing additional voluntary contribution schemes
- tax-allowable payments to charity.

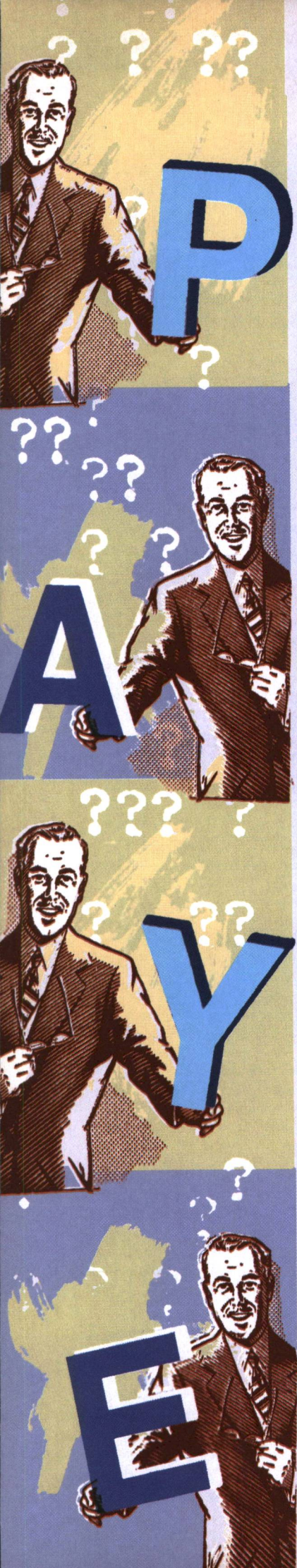
With some payments, such as those to personal and stakeholder pensions and charitable gifts, you receive basic-rate tax relief by paying less to start with. If so, there will be an entry only if you are entitled to higher-rate tax relief (40 per cent).

Restricted allowances

Some allowances don't qualify for full tax relief. Instead, a percentage of the allowance is deducted from your tax ▶

WHAT PAYE CODES MEAN

L	You get the basic personal allowance
H	You get the basic personal allowance plus the full children's tax credit and you are likely to pay basic-rate tax
A	You get the basic personal allowance and one half of the children's tax credit and you are likely to pay basic-rate tax
P	You get the full age-related personal allowance for someone aged 65 to 74
V	You get full age-related personal allowance for someone aged 65 to 74 and full married couple's allowance for those born before 6 April 1935 and aged under 75 and you are likely to pay basic-rate tax
Y	You get full age-related personal allowance for someone aged 75 or over
K	You get this if the total deductions, such as fringe benefits, exceed your allowances. The excess is added to your income each pay period
T	Used if your tax office needs to review your tax code. You can also ask your tax office to use it if you don't want your employer to know personal details (such as your age or marital status)
DO	All your earnings at this source are taxed at the higher rate, and all your allowances allocated elsewhere
BR	All your earnings at this source are taxed at basic rate and all your allowances have been given elsewhere
NT	You pay no tax on this income



bill. Married couple's allowance and maintenance relief are examples of restricted allowances and still apply if either partner to the marriage was born before 6 April 1935. If you are one of the people eligible for a restricted allowance, the full amount of the allowance is shown on the left-hand side of your coding notice and an adjustment called 'Allowance Restriction' is given on the right-hand side.

The new children's tax credit is another example of a restricted allowance. This can be claimed by single people and couples (whether married or not) of any age if they have a child under 16 living with them. The full amount of the credit is given on the left-hand side of your coding notice, and an entry called children's tax credit restriction is on the right. To check the relief you've been given, deduct the restriction from the full allowance and multiply the result by your highest rate of tax. The answer should be within a few pounds of the relief that's due. The actual relief due on all restricted allowances is currently 10 per cent of the allowance.

Deductions

Entries shown in the right-hand column reduce your allowances, so that you get less tax-free pay. They include:

- most fringe benefits from your job, such as private medical insurance
- other income from working that is not taxed under PAYE, such as part-time freelance earnings or commission
- taxable state pensions and benefits
- investment income received before tax (see p21)
- taxable rental income.

If you owe tax from a previous year and it is not being collected in one payment, it will appear as tax underpaid. This reduces your code sufficiently for you to pay extra tax equal to the amount you owe.

If you are a higher-rate taxpayer, the additional tax you owe on investment income is collected under the heading higher rate adjustment.

SPECIAL CASES

When you start or return to work, change jobs or stop work, your income is likely to change. You may find that you pay the wrong amount of tax.

Your first job

Your employer should give you form P46 to complete. If you earn £87 a week or more (in

CODING NOTICE

Alex Springs received his coding notice in February 2001 for the 2001-2002 tax year. On the left is Alex's **personal allowance** of £4,535 and the new **children's tax credit (CTC)**, which he can claim because he has children under 16. The credit shown is £4,420 – the level announced last November. CTC was increased to £5,200 in the March 2001 budget but Alex received his code before the budget so the lower amount is shown. Alex will eventually receive another code giving the higher level, backdated to April 2001. **Taxable expenses payments** represents some taxable expenses Alex received from his employer in 2000-2001. **Children's tax credit rest'n** adjusts the tax relief on the £4,420 CTC, as only 10 per cent of the credit is given against tax (£442). Alex can check this figure by deducting it from the credit given and multiplying the result by his highest rate of tax. Alex is a basic rate taxpayer so his calculation is: 4420 – 2410 = 2010. 22 per cent of 2010 = 442. Alex's allowances exceed his deductions. He gets the basic personal allowance, pays basic-rate tax and is eligible for children's tax credit, so gets an H code.

Inland Revenue

PAYE Coding Notice

This form shows your tax code for the tax year 2001-02

Please keep all your coding notices. You may need to refer to them if you have to fill in a Tax Return.

MR A SPRINGS
100 ACACIA AVENUE
NEW TOWN
MIDSHIRE MD9 1AB

Issued by:

MRS Z BLACK
HM INSPECTOR OF TAXES
MIDSHIRE 1
CROWN BUILDINGS
NEW TOWN
MIDSHIRE MD9 9BC

Tax Office telephone	Date of issue
01234 567890	22 FEB 2001
Tax reference	National Insurance number
222/A900	AB 12 34 56 Z

Please quote your Tax reference and National Insurance number if you contact us

Your tax code for the year shown above is **617H**

This tax code is used to deduct tax payable on your income from ANYOLD BUSINESS LTD

If you move to another job, your new employer will normally continue to use this tax code.
The tax code is made up as follows:

The '*See note*' columns below refer to the numbered notes in the guidance leaflet P3 *Understanding Your Tax Code*. Leaflet P3 also tells you about the **letter part** of your tax code.

Check that the details are correct. If you think they are wrong, or you have any queries, contact your Tax Office (details above).

This coding notice replaces any previous notice for the year. Pass it to your tax adviser if you have one.

See note	Your tax allowances	£
01	PERSONAL ALLOWANCE	4535
04	CHILDRENS' TAX CREDIT	4420
	Total allowances	8955

See note	Amounts taken away from your total allowances	£
30	TAXABLE EXPENSES PAYMENTS	370
	CHILDRENS' TAX CREDIT REST'N	2410
	Total deductions	2780

Your tax free amount for the year is £ 6175 , making your Tax Code 617H

2001-2002), this is sent to your tax office, otherwise the employer keeps the form. Form P46 enables your employer to tell the Revenue about your job and to work out which PAYE code to use.

If this is your first regular job since full-time education, and you haven't been receiving jobseekers' allowance because of unemployment, you will be given an 'emergency' tax code (453L for the 2001-2002 tax year). This assumes that the only allowance you are entitled to is the personal allowance. You can therefore earn one-twelfth of the personal allowance each month of the tax year before paying tax.

Tax won't be deducted until the tax-free pay you were entitled to in the months that you weren't working has been used up. So, if you are on code 453L during this tax year, and your first monthly pay day is in the fourth month of the tax year, you are entitled to earn £1,512 (one-twelfth of £4,535 x 4) before tax starts to become due.

If you've worked before

When you change jobs, your previous employer should give you form P45. This shows your PAYE code and the tax deducted from your total pay for the year to date. Give it to your new employer so the correct amount of tax can be deducted from your pay.

If you don't or can't give a P45 to your new employer, you will be given form P46 as for your first job. Until the Revenue sorts out your code, your employer will usually operate the emergency code on a 'week one' or 'month one' basis. This works as though each week or month is the first one of the tax year, and no account is taken of any free-of-tax pay due from the beginning of the tax year to the time you started working. You may pay too much tax for a while, but when the Revenue allocates your proper code, your employer will refund any overpayment.

Income less than expected

Because your tax-free pay is spread over the tax year, if you earn less than this amount in any pay period (because of sickness, for example, or unemployment), you will pay too much tax. Your employer or Jobcentre normally refunds this automatically.

If you're off work

Sick pay from your employer (including statutory sick pay) is normally taxable, and the tax is collected through PAYE. But if the amount you've received is less than the tax-free pay to which you're entitled, you will receive a refund of tax already paid in addition to the sick pay.

Statutory maternity pay and any maternity pay from your employer are also taxable through the PAYE system. The state maternity allowance, however, isn't taxable.

If you're unemployed

You may become unemployed before you have used up all of the tax-free pay to which you are entitled. If so, any unused entitlement will be set against the taxable amount of any jobseekers' allowance or income support you receive.

When you stop claiming benefit, or at the end of the tax year if this is first, the Jobcentre will work out your tax position. It will send you a refund if you have paid too much tax.

Your former employer should give you a P45 when you become unemployed; give this to the benefits office. If you are still not working at the end of the year, you will get a P60U, which gives details of all the taxable benefits that you've received and the tax you've paid. When you find a job, fill in the form in the back of booklet ES40 (which explains about signing on) and return it to the Jobcentre, which will give you a P45. If you've paid too much tax, the Jobcentre or your new employer will give you a refund.

New allowances or outgoings

Your code may change if you become entitled to a new allowance or incur a new outgoing during the tax year (such as pension payments or gifts to charity). Tell your tax office and ask for a new code – otherwise you may pay too much tax, which will have to be refunded.

Also tell your tax office about any change that might reduce your code – for example, if you stop making contributions to a pension plan on which you get tax relief through the PAYE system. If you don't, you'll have more tax to pay later on.

More than one job

If you have two or more jobs, you'll have a separate tax code for each. Personal allowances will be given against what you, or your tax office, regard as your main employment.

Your gross pay from your second job will probably all be taxed at the basic rate (or 40 per cent if you are a higher-rate taxpayer). Don't worry if this results in any under- or over-payment of tax for the year as a whole – an adjustment will be made at the end of the tax year.

However, there is a different system if you expect to earn less than the personal allowance during the tax year, for example, if you are a student. If this applies to you, you can ask your tax office to 'split' your personal allowance between both jobs, so that you don't pay tax on either of them.

Checking tax code pays off

Even people who work on tax guides get it wrong sometimes. Barbara White, the *Which? Tax Saving Guide* production editor, inadvertently underpaid tax on some savings. When she realised what she'd done, she rang her tax office and came clean. The tax office asked her to send in her P60 to check she'd paid the right tax in previous years, then worked out how much tax she owed. It came to less than £100 so Barbara sent off a cheque.

However, a few months later she received a new PAYE coding notice. Luckily, she checked it – because the Revenue had altered her tax code so that the underpaid tax would be collected through her salary. If she hadn't spotted it she would have paid back the tax twice. She phoned her tax office and explained what had happened. It apologised and reissued another coding notice – this time with her correct code.

MORE HELP

INLAND REVENUE LEAFLETS

IR33 Income tax and school leavers
IR34 PAYE
IR41 Income tax and job seekers
IR60 Income tax and students

FRINGE BENEFITS

You may not have to pay tax on all the perks your employer gives you. Here are the tax rules for the most common ones.

Your employer may give you fringe benefits – also known as benefits in kind, or perks. These are, broadly, non-cash items on top of your salary.

The taxable value of most fringe benefits is the cost to your employer of providing them. But if your employer gives you something to keep, you generally pay tax on the item's market value. Anything you pay towards the cost of a perk is deducted when working out the taxable value. A key advantage of fringe benefits for employees is that you don't have to pay National Insurance on them – a saving of £100 on a benefit worth £1,000 at the standard NI rate.

TAX-FREE BENEFITS

You won't normally pay tax on:

- your employer's contributions to an approved or statutory pension scheme
- membership fees and subscriptions paid to approved professional bodies
- life and sick pay insurance (if certain conditions are met), routine health checks and medical screening
- the first 15p of luncheon vouchers each working day
- nurseries or play schemes provided in full or part by your employer (as long as it's wholly or partly responsible for financing or managing the nursery or play scheme). Childcare vouchers are taxable
- free or subsidised canteen meals provided for employees generally
- protective clothing necessary for your job, or a recognisable uniform you are required to wear
- small personal expenses, such as laundry or calls home, paid by your employer when you're away on business, provided they don't exceed £5 a night (£10 outside UK)
- specified removal and relocation expenses when you have to move to a new job or are transferred and need to change your main home, up to a maximum of £8,000 a move
- genuinely personal wedding or retirement gifts (note: a cash gift at retirement will attract tax at normal rates)
- long service awards such as gifts or shares. You must have worked at least 20 years with your employer, and the value must not exceed £20 per year of service. Cash awards will be taxed at normal rates
- gifts and goods from business contacts costing up to £150, provided that the gift is not in recognition of particular services and hasn't been procured by your own employer
- the value of any entertainment, such as a lunch, provided by someone other than your employer (or its associate companies)
- annual staff functions (such as Christmas parties) that are open to all staff and cost £75 a head or less a year
- prizes, totalling a maximum of £5,000, for certain ideas put forward through staff suggestion schemes
- books and fees paid for by your employer for some external training courses. Extra travel expenses and living costs that your employer pays may not be taxable either
- redundancy counselling services
- retraining courses that an ex-employer pays for (they must begin within one year after you leave)
- in-house sports facilities available to all employees
- taxis home paid for by employers if you occasionally work until at least 9pm. Public transport must have stopped or it would be unreasonable to use it (for safety reasons, say)
- free parking at or near work
- travel and subsistence for disabled employees unable to use public transport (this also applies to all employees if public transport is disrupted)
- essential accommodation, travel and subsistence payments if you are temporarily absent from your permanent workplace for up to 24 months
- the cost of defending some legal claims against you as an employee (but not criminal fines such as parking fines), or the cost of any insurance that your employer pays to cover you against legal claims.

TAXABLE BENEFITS

The following fringe benefits are taxable, but only if you earn over £8,500 (see opposite) or are a director.

MORE HELP

INLAND REVENUE BOOKLET

IR480 Expenses and benefits – a tax guide

INLAND REVENUE LEAFLETS

IR115 Tax and childcare
IR125 Using your own car for work
IR134 Relocation packages
IR136 Company vans
IR172 Company cars

INLAND REVENUE HELPSHEETS

IR201 Vouchers, credit cards and tokens
IR202 Living accommodation
IR203 Car benefits and car fuel benefits

Loans of money
If your employer lends you money, the taxable value is based on the difference between the interest you pay and the official rate of interest – 6.25 per cent for 2000-2001 and 2001-2002. The Revenue now sets the rate for the whole tax year and announces it just before the tax year begins.

There is no tax on cheap or interest-free loans of £5,000 or less. If the loan is for more than this, the interest on the whole amount is taxable. There's also no tax if your employer runs a lending business and lends money to you on the same terms as to the public. But any part of the loan your employer waives is taxed as income, and in certain cases could be taxed as a dividend.

Other common benefits
You pay tax on medical insurance premiums paid by your employer. For private use of a van, you pay tax on a flat amount of £500 a year (less if it is four years old or more, or if it is shared).

Low-rent accommodation
Low-rent and rent-free accommodation is taxable unless one of the following applies (although there are special rules if you are a director):

- you have to live in the home to do your job properly (as a caretaker, say)
- living in the home enables you to do your job better, and is customary in your kind of employment
- there is a special threat to your security, and you live in your home as part of special security arrangements.

If none of these applies, the taxable value is usually the greater of the gross rateable value of the home or the rent your employer pays, less anything you pay. If there is no rateable value, your employer must agree a value with the Inland Revenue. If your accommodation costs more than £75,000, you have to pay an additional charge.

RULES FOR LOW EARNERS

Low earners don't pay tax on most fringe benefits, including company cars and fuel. However, they are taxed on benefits that can be sold, or otherwise turned into money – but even then only on their second-hand value. See IR booklet 480 *Expenses and benefits – a tax guide* for full details. All this applies only if you earn less than £8,500 a year – that is, if the pro rata rate of your yearly earnings, plus the value of benefits and expense payments (whether or not they are taxable), is less than £8,500. So if you earned a salary of £7,000 a year and had a perk (a car, say) with a taxable value of £2,000, you would be over the limit. You would also be over the limit if you earned £4,500 (including perks and expenses) for six months' work.

If you have two unconnected jobs with different employers, the £8,500 limit applies to each job. If you have more than one job with the same (or an associated) employer, these are treated as one job for deciding whether the £8,500 limit is reached.

RULES FOR DIRECTORS

If you are a director of a company, you always pay tax on fringe benefits unless all of the following apply:

- you (together with close family members and certain other associates) own or control a total of 5 per cent or less of shares in the company
- you are a full-time working director, or work for a charity or non-profit-making company
- you are not also a director of an associated company
- you are below the £8,500 limit.

INCENTIVE SCHEMES

Below we explain the ways you can receive shares in your employer's company tax free.

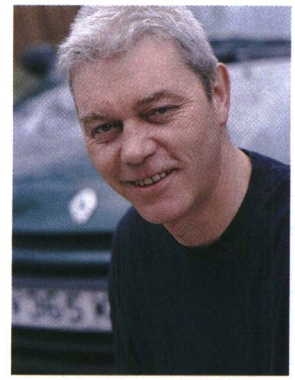
All employee share ownership plans (Aesops)
Since July 2000 employers have been able to offer this new incentive scheme. Here are some of its features:

- up to £3,000 of shares a year can be given to each employee free of tax and NI
- some or all of these shares can be awarded to employees for reaching performance targets
- employees can buy shares known as partnership shares out of gross income (before tax and NI). For each share you buy, your employer has the option of giving you an extra one or two shares for free.

Approved profit sharing
Under approved profit-sharing (APS) schemes your employer can give you shares free of income tax, worth up to £3,000 a year (or 10 per cent of your earnings, if higher, up to £8,000 a year). Following the launch of Aesops (see left) last year, APS schemes will lose their tax-free benefits next year. Tax-free awards of shares under APS schemes will be allowed up to 31 December 2002.

SAYE share options
Under these schemes, your company gives you the right, or option, to buy its shares in the future at a price fixed now and up to 20 per cent below the current market price. You must buy the shares with the proceeds of a save-as-you-earn

New rates for greener drivers



Rob uses his own 1400cc Renault Clio for work and receives a mileage allowance from his employer. Rob's employer runs a fixed profit car scheme (FPCS) which pays the same tax-free rate – 37.8p per mile – for all cars with an engine size of 1200cc or over. This beats the Revenue's 2000-2001 authorised mileage rates for cars up to 1500cc, although it's less generous for cars over that size.

The Revenue's authorised mileage rates have sometimes been more generous than employers' FPCS rates – particularly for bigger cars. However, in his pre-budget statement, the Chancellor announced plans to reform authorised mileage rates to encourage the use of smaller cars for business. From April 2001 the Revenue's rates for smaller cars went up to 40p for the first 4,000 miles and 25p above that (see table, left). The rates for bigger cars didn't change. From April 2002, it is proposed that one flat rate of 40p per mile for all business mileage up to 10,000 will apply.

AUTHORISED MILEAGE RATES 2001-2002

Engine size	Relief per business mile: 0 to 4,000	Relief per business mile: 4,000+
up to 1500cc	40p	25p
1501 to 2000cc	45p	25p
over 2000cc	63p	36p

(SAYE) plan, which normally runs for three, five or seven years. You can pay in between £5 and £250 a month. All employees must be eligible. These schemes won't be affected by the all-employee share ownership plan.

Approved share options

Company share option plans give you an option to buy shares in your company in the future at a price fixed when the option is granted. Your option will not be taxed when you exercise it to buy shares as long as the scheme is still approved when you exercise the option, you exercise it between three and ten years after you received it, and you haven't exercised any other similar options in the last three years. In addition, if you got your option after 16 July 1995, the price you pay for the shares must not be below the market value when you were given the option, and the value of the shares under option must not exceed £30,000. These schemes also won't be affected by the all-employee share ownership plan.

COMPANY CARS

You usually pay tax on a company car only if you earn £8,500 a year or more including benefits. The basic taxable value of the car is 35 per cent of its list price, plus other charges (see below). But you may be able to cut your bill by claiming certain reductions.

The car's price

A car's price for tax purposes is usually its list price when first registered (or £80,000 if less) including: VAT and car tax if paid (but not the annual road tax); delivery charges; the list price of any accessory fitted before you get the car (including VAT, delivery and fitting); and any accessories, such as alloy wheels, that cost more than £100 (including VAT and delivery) fitted after you get the car – the increased price applies from the beginning of the tax year in which the accessory was fitted. Where there is no list price (with classic cars, for example), you have to agree the price with the Revenue.

Anything that an employer pays to convert a company car for use by a disabled person is excluded, provided certain conditions are met. Anything you pay towards the purchase price of the car, or its accessories up to a limit of £5,000, reduces the taxable price of the car by an equivalent amount.

Reductions

The taxable value is reduced in several ways, as shown in the bottom table. If you qualify for more than one reduction, you apply each in turn. So if you travel 20,000 business miles a year, the taxable value is 15 per cent of the list price. If your car is five years old, this figure can then be reduced by a quarter. Anything that you pay for private use of the car should be deducted last.

If you use more than one car in succession in a tax year, the 2,500- and 18,000-mile thresholds apply to each car separately, but are reduced in proportion to the number of days you had each car during the year.

Change in tax rules

From April 2002 the way tax is assessed on company cars is changing. The tax will still be based on a percentage of the car's list price, but the amount of business miles you drive will become irrelevant. Instead, tax will be assessed on the level of the car's carbon dioxide emissions to encourage more environmentally friendly motoring. Cars with the lowest emissions (165 grams per kilometre (g/km) or less in 2002-2003) will attract the lowest tax charge of 15 per cent. There will then be a 1 per cent rise in tax for every 5g/km rise in emissions of carbon dioxide, up to a top rate of 35 per cent tax for cars with emissions of 265g/km. These parameters will be reduced by 10g/km in both 2003-2004 and 2004-2005 (the 35 per cent tax rate will start at 255g/km and then 245g/km in those years).

If you are due a new company car this year, think carefully about how long you are likely to keep it. With most company cars being kept three years or more, it is worth considering a smaller, greener model with low emissions. You might save yourself a hefty tax bill in the coming tax years.

Fuel charges

Any fuel that your employer buys, but which is for your private use, is taxable unless you repay it all. However, the taxable value is worked out on the size of the car, not on how much fuel is paid for (see the 'Fuel taxable values' table).

To work out the tax, multiply the figure for your car by your top rate of tax. You're not taxed on fuel that you use solely for business, but the journey that you make from home to your permanent workplace counts as private use.

YOUR OWN CAR

If you use your car for work, employers usually reimburse your expenses. Most pay a set amount for each business mile you drive to cover your petrol. Some also pay regular fixed sums for wear and tear. These payments are usually paid with no tax deducted, but are taxable over a certain limit. There are two ways to calculate whether you owe any tax:

Fixed profit car scheme

Some employers run a fixed profit car scheme (FPCS). They agree a table (specific to each employer) with the Revenue that gives a set amount per mile and an average taxable profit for different sizes of car and ranges of business miles. As the table is based on averages, you may be better off using the Revenue's authorised mileage rates for tax purposes (but see 'New rates for greener drivers', p9).

Inland Revenue rates

You pay tax on any allowance you receive over these rates. If you're in an FPCS, you can use the Revenue's rates, rather than your FPCS table, to work out your tax bill if it means you pay less tax. If your FPCS rates are lower than the authorised ones, you might be due a tax refund.

FUEL TAXABLE VALUES 2001-2002

Engine size	Petrol (£)	Diesel (£)
up to 1400cc	1,930	2,460
1401 to 2000cc	2,460	2,460
over 2000cc	3,600	3,600

TAXABLE VALUE OF COMPANY CARS 2001-2002 TAX YEAR

How you use the car	Amount of tax charge
You drive less than 2,500 business miles in the tax year	35 per cent
You drive 2,500 to 17,999 business miles in the tax year	25 per cent
You drive 18,000 or more business miles in the tax year	15 per cent
Your car is four or more years old at the end of the tax year	Deduct one quarter from the tax charge
You pay your employer for private use of your car	Deduct what you pay from tax charge

SELF-EMPLOYMENT

People who are self-employed enjoy more favourable tax treatment than employees. Use this chapter to ensure you make use of all the advantages of working for yourself.

If you work for yourself as a sole trader and are considered self-employed for tax purposes (taxed under Schedule D), you have greater scope to deduct business expenses from your income. You will also pay lower National Insurance contributions, although this reduces your rights to some state benefits. In this chapter we explain how to work out your tax, business expenses and allowances if you're self-employed. However, if your business is run as a limited company, the rules are different from those set out here. For more details, contact your tax office.

TAXES YOU MAY PAY

If you work for yourself, you may have to pay some or all of the following:

Income tax

If your profits from self-employment plus other income come to more than your tax-allowable outgoings and allowances, you'll have to pay income tax. If you're a partner in the business, you are treated as if you are a sole trader with business profits equal to your share of the partnership profits.

Self-employed people normally pay their tax in the January of the relevant tax year and the July following the end of that tax year. There may be a final payment in the January after that – see 'Payments on account', *Which? Tax Return Guide*, April 2001, p6.

National Insurance

This is dealt with in the chapter on National Insurance (NI) – see p15.

Value added tax

From 1 April 2001, you have to register for value added tax (VAT) if, at the end of any month, the taxable turnover of all your business activities in the year ending on the last day of that month exceeds £54,000. You must also register if you think your turnover will exceed the £54,000 limit during the next

DO YOU COUNT AS SELF-EMPLOYED?

For your work to count as self-employment, you must convince your tax office that you genuinely work for yourself and not, in reality, for an employer. Essentially, one main question needs to be answered: 'Are you in business on your own account?'. If you answer yes to the following questions, it's highly likely you will be treated as self-employed:

- Do you have the final say about how your business is run? For example, do you decide where you work and the hours that you work?
- Do you put your own money at risk?
- Do you bear any losses of the business, as well as keep the profits?
- Do you provide the main items of equipment, such as fax machines and computers, that you need to do your job?
- Are you free to hire people on terms you choose to do work that you have taken on? Do you pay them out of your own pocket?
- Do you have to correct any unsatisfactory work in your own time, and at your own expense?

Even if you answered no to some, or most, of the questions, you may still be self-employed. Get a copy of Inland Revenue leaflet IR56, which will tell you more. If you are still unsure, arrange an appointment with your own tax office or a local Inland Revenue enquiry office. They can give you a written decision about your employment status.

30 days. At or below this limit, you can choose whether to register for VAT.

Registration can cut your costs but requires more record-keeping. Contact your local VAT office (look up 'Customs and Excise' in the phone book) for details. If you're not registered, you can't reclaim VAT on things you buy for business, but you use prices including VAT when recording expenses and allowances.

The March 2001 budget proposed a new optional flat rate scheme for businesses with a taxable turnover under £100,000. The new scheme means these businesses can avoid having to account internally for VAT on all of their purchases and sales. Instead VAT would be calculated as a percentage of their taxable turnover. The government is consulting on the new scheme this summer.

Business rates

If you have business premises, such as a shop or office, you must pay the uniform business rate. This also applies if part of your home is used exclusively for business. If the part of your home used for business is also used for domestic purposes, business rates shouldn't be levied, and you may be able to claim part of your council tax as an allowable business expense.

SPOUSES CAN SAVE TAX

If your spouse helps with the business and pays tax at a lower rate than you, a simple way to reduce your profits is to pay them a wage. As long as this is a reasonable amount, it counts as a tax-allowable expense and can be deducted from profits. But if their salary reaches £87 a week (in 2001-2002) they have to pay National Insurance, and you will be liable for employer's National Insurance.

TAXABLE PROFITS

Broadly speaking, you pay tax on your yearly takings less allowable business expenses, provided they are incurred wholly and exclusively for the purpose of the business.

The main expenses you can claim are explained in 'What you can claim', p14. Strictly speaking, any payment partly for business and partly for personal reasons is not allowable. But, in practice, the Inland Revenue lets you claim a proportion of some joint expenses, such as the cost of running a car used partly for business, and some domestic bills if you work from home.

There may also be adjustments to make before you can arrive at your taxable profit, such as allowances for buying capital equipment. These are explained below.

Stock values

You can deduct from profits the cost of raw materials or goods bought for resale, but only if they are actually sold during the accounting year. Their value is generally the lower of their cost to you or their market value. If stock is unsold at the end of the year, you can carry forward the cost and deduct it when you sell the stock.

Money owed

Accounts have to be kept on an accruals basis. This means you must include income in your accounts when you sell goods or do work, and include expenses when they are due, regardless of whether you have received or made any payment.

Capital allowances

When you buy capital equipment (items that aren't for resale and that are of lasting use to the business, such as cars), you do not deduct their cost from profits at the time you buy them. However, you can still receive tax relief on these sorts of things by claiming capital allowances.

These allowances are worked out as follows. The cost of each capital item is added to a pool of expenditure. When you calculate your taxable profits, you can usually deduct up to 25 per cent from the pool as a writing-down allowance. However, small or medium-sized businesses can claim a first year allowance of 40 per cent on certain items in the year of purchase. Also, 100 per cent of the cost of information technology purchases are allowable against profits for purchases in the three tax years beginning April 2000.

If you sell a capital item, the sale proceeds are deducted from the pool before the writing-down allowance is worked out. If the proceeds of all the items you sell come to more than the value of the pool, the excess (which is known as a balancing charge) is added to your profits for the year and taxed.

If you sell an item for less than its written-down value, you can't normally claim tax relief on the whole of the difference between the cost and sale prices until the business ceases.

You can claim tax relief earlier if you have elected to have the item treated as a short-life asset. These are items with an expected life of less than five years. You can claim tax relief when you dispose of them. These must be put in other separate pools to capital items.

You also need to keep separate pools for assets used both privately and for business – the allowance you get is in proportion to your business use. Prior to the 2000 budget you had to put expenditure on cars costing less than £12,000

BECOMING SELF EMPLOYED?

Here are some things you should do if you are becoming self-employed:

- get a copy of the Inland Revenue's new free pack *Starting up in business*. It tells you everything you need to know about tax (including VAT) and National Insurance
- register with the Inland Revenue within three months from the last day of the month in which you started your self-employment. If you don't, you risk a fine of £100. You can register by using form CSF1, which is included in the Revenue's pack or available from any tax office. You can also register by ringing the Inland Revenue helpline for the newly self-employed on 08459 154515
- keep a list of fixed assets such as cars and office equipment
- keep cash books recording cash paid to and taken out of the bank, and any petty cash dealings
- set up an accounting system detailing sales and purchases, and sort purchases into types (stationery, travel, and so on)
- keep records of stocks of raw materials and any other goods you've bought, used or sold
- include items in your accounts that you already own but may use for business, such as a computer. You can claim capital allowances and may be able to recover VAT
- get written receipts and file them in date order. Record items without receipts in a notebook
- save money to cover your tax bills in January and July
- record business mileage, petrol, and all running costs if your car is used solely or partly for business
- choose your accounting year-end
- count any expenditure before you start your business as pre-trading expenses
- set any first-year losses against other income
- check that you have adequate pension arrangements and life insurance. Consider taking out permanent health insurance in case you're ill.

into a separate pool. However, this requirement was removed from April 2000.

Using your losses

You can use losses to reduce your overall tax liability now or in the future. They can even be used to reduce tax due on income or profits you received in previous years.

A loss incurred in an accounting year can be:

- carried forward indefinitely to set against profits from the same business in future years
- set against any other type of income in the current tax year. If this does not use up the whole loss, you can set the remainder against any capital gains for the year if you wish
- set against any other type of income for the previous tax year, provided the business was carried on in that year. If this does not use up the whole loss, you can set the remainder against any capital gains for the previous year
- set against other income (but not capital gains) from the previous three tax years if the loss is incurred in the first four tax years of your business
- set against profits from the business over the previous three years if the loss is incurred in the last 12 months before closing down.

Pre-trading expenses

If you incur expenses before you start trading, you may still be able to claim these as pre-trading costs. Any expenses that would be allowable if incurred after the business had started could be treated as pre-trading expenses.

Money spent on business premises, for example, rent and rates, in the seven years before your business starts will probably count.

STARTING UP AND CLOSING DOWN

Special rules apply in the first and last years of your business if you are self-employed – the main ones are explained here.

Starting up

When you start in business, you choose an accounting period – the 12-month period over which your tax will be worked out. You can choose any date as the end of your accounting period.

If you want to keep things simple, run your accounting year the same as the tax year (called fiscal accounting). However, this means you don't have long after your year-end to complete your accounts and do your return.

If you expect your profits to rise steadily, consider a year-end early in the tax year (30 April, say). This maximises the delay between earning your profits and paying tax, which is good for cash flow. The downside is that a year-end early in the tax year means carrying forward higher overlap profits (see right).

In the first year, you're taxed on your actual profits from the date your business started up until the end of the tax year in April. This is worked out on a proportion of the profits in your first accounting period.

If, say, you started up on 1 January 2001 and your first accounting period ends on 31 December 2001, your tax bill for 2000-2001 is based on the assumed profit in the period from 1 January to 5 April 2001. So if your profit for the 2001 accounting period is £10,000, your 2000-2001 taxable profit will be 95/365 (days) x £10,000 = £2,602.

In the second tax year, you are taxed on the profits for the 12 months up to the accounting date in that year, as long as you've been in business for at least a year.

If you're preparing your first accounts and they cover less than a year, you are taxed on your profits for the first 12 months of trading. If there is no accounting date in the second tax year, you are taxed on your profits for the tax year itself.

In the third and subsequent years, businesses are taxed on the normal current-year basis – tax is based on profits for the accounting year ending during the current tax year.

Overlap profits

Because of the way profits are taxed when you first set up in business, under the opening-year rules some profits may be taxed more than once. They are called overlap profits and you get overlap relief against this excess taxation – but not until you close your business, or sooner if you change your accounting date to one falling later in the tax year.

You have no overlap profit and avoid the complications of opening year rules if you choose fiscal accounting. This means having an accounting year which coincides with the tax year; an end-March accounting date also qualifies.

The drawbacks are that if your profits increase, you pay tax on them earlier, and you also have less time in which to draw up your accounts than if you choose an accounting date that's earlier in the tax year.

Keep accurate records

If your business is quite straightforward, you may be ▶

MORE HELP

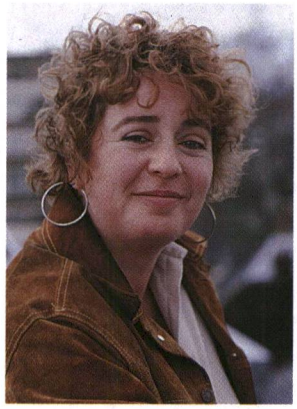
INLAND REVENUE LEAFLETS

CWL1 Starting your own business?
CWL2 National Insurance for the self-employed
IR56 Employed or self-employed?
IR72 Inland Revenue investigations
SA/BK3 Self-assessment – a guide to keeping records for the self-employed

INLAND REVENUE HELPSHEETS

IR220 More than one business
IR222 How to calculate your taxable profits
IR227 Losses
IR229 Information from your accounts

Double National Insurance



Adrienne Wyper is a freelance journalist and self-employed, although for tax and NI purposes she is often treated as an employee by the publishing companies she does contract work for. This means that during the tax year Adrienne has both self-employed and employed earnings and is liable to pay both employee (Class1) and self-employed (Class 2 and Class 4) NI contributions. There is a maximum amount of NI that an individual can pay during the year, and Adrienne can apply to defer payment of Class 2 and/or Class 4 NI if she thinks she might go over this.

Alternatively, she can apply for a refund if she overpays NI. For tax year 2001-2002, Adrienne would be entitled to a refund of Class 2 contributions if she pays more than £2,589.65 in Class 1 contributions, or a refund of Class 4 contributions if she pays more than £1,884.80 in Class 1, 2 and 4 contributions. See Inland Revenue leaflet CA72 for further information.

able to handle your tax affairs yourself. However, even if you use an accountant, you're still responsible for your own tax.

It is a legal requirement for all taxpayers to keep adequate records to back up the information provided on their tax return (although you don't need to send them in with it). These records must be kept for five years from 31 January following the relevant tax year – see Revenue booklet SA/BK3.

Closing down

You are taxed in the year you close down on your profits from the accounting date on which the tax for the previous year was based, up to the date of closure, less any overlap profit brought forward.

For example, if you have a 30 April accounting date, your 2000-2001 tax will have been based on your profit for the year to 30 April 2000. If you cease trading on 31 March 2002, you'll be taxed in 2001-2002 on the profits for the 23 months to 31 March 2002, but will have 11 months' overlap relief to set against these.

Check out the accounting date

Here's why the accounting date you choose is crucial. Imagine you've been in business for several years and your accounting year ends on 5 April. You would record taxable profits for the year to 5 April 2001 on your 2000-2001 tax return. You pay tax on this in January and July 2001 and January 2002.

If your accounting year ends on 30 April, you enter profits for the year to 30 April 2001 on your 2001-2002 return (as your accounting year ends in that tax year). You'd pay tax in January and July 2002 and January 2003.

This gives an extra year to pay tax and prepare records, even though the period covered is largely the same (but see 'Overlap profits', p13).

WHAT YOU CAN CLAIM

Here, we set out the main expenses that self-employed people can claim for, and those that they can't. An expense allowable for one business may not be for another. If in doubt, claim.

✓ **means normally allowed**

✗ means normally not allowed

✓ **The cost of goods for resale and the cost of raw materials; discounts on sales; payments to subcontractors and the cost of materials supplied in the construction industry; fuel costs if your primary business is road transport (but not any private fuel); the cost of small tools.**

✓ **Recruitment agency fees; wages, salaries and redundancy payments to employees; insurance costs and pension benefits for employees and their dependants; training costs; the cost of temporary secondment of your employees to certain charitable and educational organisations; some types of childcare provision for the children of your employees; employer's NI contributions for employees; the cost of hiring locums or subcontractors; insurance premiums to cover providing locums in the event of your being ill; keyman insurance cover for employees (although the benefits from the policy may be taxed); staff entertainment such as the Christmas party (up to certain limits).**

✗ Your own wages, salary or drawings from the business, wages paid to family members if these are excessive for the work done; the cost of premises and equipment for a workplace crèche (although this may qualify for capital allowances); your own National Insurance contributions and income tax; your own pension costs (although you can get personal tax relief on these); your own life, keyman, accident, permanent health and private medical insurance.

✓ **Heating; lighting; cleaning; water rates; rent for business premises; business rates. If you work from home: a proportion of the lighting, heating, cleaning and insurance costs; a proportion of rent (and domestic rates in Northern Ireland) or of mortgage interest if part of your home is used exclusively for business (although there may then be a capital gains tax bill when you sell your home); probably a proportion of council tax, although the rules are unclear depending on whether you simply work from home or use part of the home exclusively for business.**

✗ The initial cost of buildings (but part may qualify for a capital allowance); council tax relating to the private use of your main home; a proportion of other bills relating to your private use of the home.

✓ **General maintenance of business premises (a proportion if you work from home); repairs to business equipment.**

✗ Alterations and improvements to business premises (although these may qualify for capital allowances); any proportion relating to private use.

✓ **Telephone bills (but only a proportion of these if you also use the phone for private calls); postage; stationery; delivery costs; printing; software with a limited lifetime; books and magazines used only for business purposes.**

✗ Most payments you make to clubs, charities, etc; money paid as result of extortion.

✓ **The running costs of your own car, such as insurance, servicing, repairs, road tax and petrol (a proportion only if it is also used privately); the cost of hiring cars or vans; parking costs.**

✗ Travel between your home and your workplace; the cost of buying a vehicle (although this may qualify for capital allowances); parking and motoring fines.

✓ **Travel and accommodation on business trips and travel between different places of work; the cost of travel from the UK (and back again) to carry out business that is performed outside the UK, provided that the trips are exclusively for business reasons.**

✗ Meals, except a reasonable amount for breakfast and evening meals on overnight trips.

✓ **Newspaper and magazine advertisements, mailshots and other forms of promotion; free samples; gifts up to £50 (from 6 April 2001) a year to any one person, provided that they advertise your business and the gifts are not food, drink, tobacco or vouchers for goods.**

✗ Any business entertainment such as lunches with clients; most gifts.

✓ **Accountants' fees; some solicitors' fees; some costs of architects and surveyors; the cost of your professional indemnity insurance.**

✗ Legal fees and fines if you break the law; the cost of settling tax disputes.

✓ **Money owed to you which is unlikely to be paid.**

✗ General reserves for bad debts.

✓ **Interest on, and cost of arranging, business overdrafts and loans.**

✗ Your capital repayments; interest on overdue tax.

✓ **Bank charges, credit card charges, and the interest element of hire purchase charges (the amount you pay less the cash price); leasing costs.**

✗ Capital repayments; the capital element of hire purchase charges.

✓ **Special clothing for work; fees paid to register trade marks and designs.**

✗ The cost of clothes which could be worn for non-work purposes; the cost of buying a patent (although this qualifies as a capital allowance).

NATIONAL INSURANCE

Most people don't think of National Insurance as a tax – yet that's what it is. The amount you pay is linked to earnings, and your contributions are used to fund most of the social security system. What you pay determines which social security benefits you receive.

The majority of people who work pay National Insurance contributions (NICs) – but there are different classes depending on your status.

RULES FOR EMPLOYEES

Employees pay Class 1 NICs, which entitle them to contribution-based jobseekers' allowance, incapacity benefit, state retirement pension, state earnings related pension (Serps), bereavement benefits and maternity allowance. The amount you receive depends on your contributions – DSS leaflets tell you how many you need to qualify.

You have to pay NICs on all wages, salaries, commission, profit-related pay and overtime, as well as on sick pay and maternity pay from your employer. However, you don't have to pay contributions on fringe benefits or most expense payments. NI is worked out on your gross earnings, before deducting pension payments, donations to charity under a payroll-giving scheme or income tax.

You pay a certain percentage of your earnings between a minimum and maximum known as the primary threshold and the upper earnings limit (UEL). From April 2001 the primary threshold is £87 a week, and the UEL is £575 a week.

If your earnings are below the primary threshold, you pay no NI. However, you still build up rights to benefits if you earn more than the lower earnings limit, which is £72 a week.

If your employer's pension scheme is contracted out of Serps you'll pay lower NICs of 8.4 per cent. If not, you can decide to contract out of Serps individually (whether or not you are in an employer's scheme). In this case your NICs will remain at 10 per cent, but part of what you pay is rebated directly into your own personal pension arrangement (this will need to be organised by yourself). Any years you are contracted out don't build up a Serps pension entitlement.

WHAT EMPLOYERS PAY

Employers must pay NICs at 11.9 per cent on all their employees' earnings over the primary threshold. There is no upper earnings limit. Unlike their employees, employers pay NICs on most taxable fringe benefits.

IF YOU'RE SELF-EMPLOYED

If you're self-employed, you pay Class 2 contributions unless your profits are less than £3,955. Below this you can elect not to pay, but for any year you don't pay, you build up no entitlement to benefits.

Class 2 contributions entitle you to incapacity benefit, maternity allowance, bereavement benefits and state basic pension (but not Serps). You pay a flat rate contribution of £2 a week for the 2001-2002 tax year.

Class 4 NI is paid on top of Class 2 if your taxable profits reach a certain limit. In 2001-2002, you pay 7 per cent on taxable profits between £4,535 and £29,900 – a maximum payment of £1,775.55. If your profits are less than the lower limit, you pay only Class 2 contributions. Class 4 contributions do not entitle you to any additional benefits.

VOLUNTARY NICS

You can pay voluntary Class 3 NICs to help qualify for the basic retirement pension and bereavement benefits if: you aren't working; you aren't liable or exempt from Class 1 or Class 2 NI; your contribution record for a particular year isn't enough to count towards state pension entitlement; or you live abroad. The Class 3 rate is £6.75 a week for 2001-2002.

You may receive National Insurance 'credits' (usually automatically), which can help you qualify for contributory state benefits if you're not working. Ask your local benefits agency for details (if you're a carer you may need to claim for this benefit).

MORE HELP

INLAND REVENUE BOOKLETS

CA01 NI for employees
CA02 NI for self-employed people with small earnings
CA04 Class 2 and 3 NI contributions

INLAND REVENUE HELPSHEET

IR220 More than one business

CLASS 1 NICS, 2000-2001	Employee (per week)
Lower earnings limit (level of earnings at which you start to build up entitlement to benefits)	£72
Earnings threshold (level of earnings at which NICs become due)	£87
Upper earnings limit (maximum income on which NICs due)	£575
Rate paid if employer scheme is contracted in to Serps	10% of earnings between £87.01 and £575 per week
Rate paid if employer scheme is contracted out of Serps	8.4% of earnings between £87.01 and £575 per week

TAX FOR OLDER PEOPLE

As you get older, your tax position may change, entitling you to receive more income free of tax.

After you retire, your income is treated for tax purposes much the same as it was before your retirement age. The big difference is that, once you reach the age of 65, you may be entitled to receive more income before you have to start paying tax.

EXTRA ALLOWANCES

Everyone gets a basic personal allowance, no matter what age they are. This is the amount of income you can receive free of tax each year. But if you turn 65 or 75 during the tax year, this allowance is increased and is known as age allowance.

Whether you qualify for the age allowance, and how much you are entitled to, depends on your total income. This is your gross taxable income, minus some tax-allowable deductions, such as payments to charity. Tax-free income such as income from Isas or National Savings certificates doesn't count against you when working out whether you're eligible for age allowance, but a gain from a taxable life insurance product (such as a single premium investment bond) might – even if the gain doesn't itself attract tax. If your total income exceeds a pre-set limit (£17,600 in 2001-2002), your age allowance is reduced by £1 for every £2 that your income is over this limit. However, the allowance can never be reduced to less than the basic personal allowance.

On p33 of our April *Which? Tax Return Guide* we included an age-allowance calculator that you can use to find out whether you are eligible. The calculator relates to the income limit set for the 2000-2001 tax year, but the method of calculation is the same for any year.

Even if your 65th birthday comes on the last day of the tax year (5 April), you can claim age allowance from the beginning of that tax year.

IF YOU ARE MARRIED

Until 5 April 2000 the married couple's allowance was available to all married people irrespective of their age. This allowance also increased when you turned 65 or 75.

However, the married couple's allowance was abolished from 6 April 2000, unless you or your spouse were born before 6 April 1935. So only married couples where at least one spouse had reached the age of 65 before 6 April 2000 kept the allowance.

If you married after the allowance was abolished, but you or your husband or wife were born before 6 April 1935, you can still claim it.

You can choose for the minimum allowance (not the higher amount related to age) to be allocated to either spouse, or split between you, but if no choice is made, the allowance will always be given to the husband.

However, the level of allowance given is always based on the husband's total income, even if:

- he qualifies only because of his wife's age
- all or part of the minimum married couple's allowance has been transferred to his wife and her total income exceeds £17,600 (for tax year 2001-2002).

If a married man's income exceeds £17,600 for this tax year, it is his age-related personal allowance that is reduced first. Once that has been reduced to the level of the basic personal allowance (£4,535 in the current tax year) he starts to lose the age-related married couple's allowance. Like the personal allowance, married couple's allowance can never be reduced to below the level of the minimum allowance – £2,070 this tax year.

How much tax relief?

The married couple's allowance isn't an amount you can receive tax free (like the personal allowance). Instead, 10 per cent of the allowance is offset against the tax you owe – reducing your final tax bill. For the 2001-2002 tax year, if you are between 65 and 74, the married couple's allowance is worth up to £536.50 off your tax bill. If you are 75 or over, it's worth up to £543.50. The minimum married couple's allowance is worth only £207.

KEEP YOUR INCOME DOWN

If your income looks as though it will exceed the total income limit of £17,600 during the

MORE HELP

INLAND REVENUE LEAFLET

IR121 Income tax and pensioners

DSS LEAFLET

NP46 A guide to retirement pensions

2001-2002 tax year, and it will cause you to lose age-related allowances, think about which investments you choose. You may be able to keep within the total income limit if, say, you switch to a tax-free investment such as an Isa or National Savings certificate (see p23).

You could also consider giving regularly to charity through Gift Aid to keep your income down. With the new Gift Aid scheme, in force from 6 April 2000, it's even easier to give to charity, and donations through the scheme are treated as tax-allowable deductions for the purpose of reducing your total income for age allowance. For example, if in 2001-2002 you gave £156 a year to charity via Gift Aid, the charity could claim £44 from the Revenue. This (grossed-up) gift would reduce your total income by £200 (see p4).

WHEN YOU RETIRE

The DSS should send you a claim form about four months before you are due to receive the state pension. This allows you to choose how and when your pension is paid. Tell your tax office at least a month in advance before you want to draw your pension, and say what you expect to earn after you retire so your PAYE code can be adjusted if necessary.

STATE PENSIONS

State pensions are paid without tax deducted, but that doesn't mean they are free of tax. All pensions you receive from the state are totalled up and added to your other taxable income to determine what tax you pay. How many years you worked and what age you retire will determine the amount and type of state pension you are entitled to.

Basic state pension

If you've paid enough National Insurance (NI) contributions, you're entitled to the full basic state pension, which from April 2001 is £72.50 a week (or £115.90 a week for couples). Men can claim it when they reach 65, and women can claim it from age 60 (although the age at which they can claim is going up in stages and will be 65 for women born after 5 March 1955).

You can defer taking this pension for up to five years, in which case your eventual pension is increased by 7.5 per cent for each year it's put off.

Married women's state pension income counts as their own for tax purposes and they can set their tax allowances against it. However, any adult dependency pension (paid to a man drawing a state pension whose wife doesn't qualify for a state pension in her own right) counts as the recipient's.

Serps

The state earnings related pension scheme (Serps) is a pension available to employees to supplement the basic state pension. It's based on the average of a slice of your earnings during your working life, provided you've made full-rate NI contributions. If you've contributed only part of the time, you'll get a lower Serps pension.

From April 2002 Serps is being replaced by a new state second pension. However, this won't affect any Serps entitlement you've built up.

Graduated pension

This scheme existed between April 1961 and April 1975. You qualify if you were an employee during any part of this period and you paid NI contributions.

Non-contributory retirement pension

This is a top-up pension for those aged 80 and over who either have no pension or whose pension is less than the normal state pension.

TAX ON YOUR EMPLOYER'S PENSION

Tax on a pension from a former employer will normally be collected under PAYE (see p5) and will already have been deducted before you receive it. When you first receive the pension, it might appear that it is being taxed at a higher rate than your earnings were before you retired. This is because the tax deducted takes into account other income that is taxable but paid before tax, such as the state pension.

PAST STATE PENSION AGE

If you work past state pension age, your state pension is simply added to your other taxable income for tax purposes (unless you've deferred it). If you pay tax through PAYE, you will receive a new coding notice from your tax office. If you're self-employed, you'll need to include it in your tax return.

NATIONAL INSURANCE

Once you reach state pension age, you don't have to pay any more National Insurance contributions (although Class 4 contributions continue to be paid until 5 April following the state pension age). The DSS will send you form CF384 when you claim your state pension – you'll need to ask for one if you work past pension age but defer your pension.

OTHER TAX RELIEFS

There are some other tax reliefs that were abolished in the March 1999 budget but still apply for some taxpayers.

Home income plans

People who were 65 and over received tax relief if they took out loans secured on their home and used the money to buy an annuity. These loans qualified for tax relief at the basic rate of tax – but only on the interest up to £30,000.

Relief was withdrawn for new schemes from 9 March 1999, but borrowers who qualified for tax relief at that time continue to receive this relief.

Maintenance relief

If you make qualifying maintenance payments you can still claim some tax relief on these, provided you or your former husband or wife were born before 6 April 1935.

If you are still eligible for tax relief, you can claim 10 per cent of the maintenance allowance as a deduction on your tax bill. For 2001-2002, the allowance is £2,070 or the amount of your qualifying maintenance payments, if less. So the maximum deduction for tax relief is £207.

Previously, maintenance agreements made on or before 15 March 1988 could attract higher tax relief, but this was abolished from 6 April 2000.

EXTRA ALLOWANCES

	2000-2001 tax year (£)
Personal allowance	
Basic	4,535
Age-related: if you're 65 to 74	5,990
Higher age-related: if you're 75 or over	6,260
Married couple's allowance[1]	
Minimum amount	2,070
Age-related: either spouse 65 to 74	5,365
Higher age-related: either spouse 75 or over	5,435

1 Relief restricted to 10 per cent. Allowance abolished from 6 April 2000 for most taxpayers. It remains for married couples where one or both parties was born before 6 April 1935 or where one person born before 6 April 1935 marries on or after 6 April 2000

INCOME FROM PROPERTY

More and more people are becoming landlords. Some let out their home because they've gone to live abroad, others let out property they've inherited. Some let rooms in their house to help pay the mortgage, and a growing number of people buy property to let as an investment.

Income from property includes rents, chargeable premiums on leases, and ground rents (feu duties in Scotland).

Although income from land and property is technically classed as investment income, it's treated for tax purposes much like income from a business. However, there are some important differences, which we've covered opposite.

HOW RENTAL INCOME IS TAXED

Rental income you receive isn't taxed like other investment income from shares, National Savings or deposit accounts. Instead, it's added to your other taxable income (from employment, self-employment and so on), and taxed at your top rate of tax (10, 22 or 40 per cent). If your rental income falls into the basic-rate tax band, it doesn't qualify for the special rate given to savings or capital gains of 20 per cent. Instead, it attracts the normal basic rate tax of 22 per cent.

You must complete the land and property supplementary pages of the tax return for most types of rental income you receive. However, income from overseas property is declared using the foreign income pages, and income from a guest house, hotel or bed and breakfast is normally declared using the self-employment pages. Ask your tax office if you are unsure.

BUSINESS INCOME VS RENTAL INCOME

Even if you own only one property and don't think of it as a 'business', there are many similarities in the way rental income and business income is treated. However, the differences, although subtle, are important, so you should be aware of how the Inland Revenue classifies the income you receive. If you are in any doubt, ask your tax office.

For the 2001-2002 tax year, you pay tax on rental income earned from the tenants' use of the property between 6 April 2001 and 5 April 2002. (You must declare rental income for the tax year it's due, even if you're not paid until the tax year is over.) If your income is from a business, however, you pay tax on the income earned in your accounting year. Your business accounting year may have a different start and end date from the tax year (see 'Starting up', p13). The other main differences are:

- business income losses can be offset against other income or capital gains, whereas rental income losses can be offset only against other rental income
- capital gains tax rollover and retirement relief (see p26) and inheritance tax business property relief (p34) are sometimes available on business income
- what you can claim as capital allowances will differ depending on whether your income is taxed as true business income or rental income.

TYPES OF RENTAL INCOME

Broadly, there are four categories that rental income might fall into. You must find out (with the help of your tax inspector if necessary) how your income is treated so that you know what reliefs and allowances you can claim.

Rent-a-room scheme

Owner-occupiers or tenants who let part of their only or main home as furnished accommodation may be able to qualify for rent-a-room relief. This means they pay no tax at all on gross rents (that is, before expenses) up to £4,250 in the 2001-2002 tax year.

Any charge you make for meals, cleaning, laundry and so on must be added to the rent received when you calculate your gross rents, and you can't deduct expenses. Where two people receive the

LIVING ABROAD

Since 6 April 1996, letting agents (or tenants if there's no agent) of a non-resident landlord must deduct tax from the rent and pay tax each quarter to the Revenue. Non-resident landlords can avoid this by applying to the Inland Revenue Financial Intermediaries and Claims Office (FICO) for agreement to receive rental income without tax deducted. For more information, call 0151 472 6000, or look at the Revenue website www.inlandrevenue.gov.uk.

rent, the exemption limit is £2,125 per person.

To claim rent-a-room relief, answer 'yes' to the relevant question on the tax return page relating to land and property. If you don't normally complete a tax return, you don't need to tell your tax office you receive rental income as long as it's all covered by the rent-a-room scheme.

If the total rent you receive from your lodger exceeds £4,250, you can choose to stay with rent-a-room, or pay tax on your profits in the normal way (see 'Better off with rent-a-room', below).

If you choose rent-a-room relief, you pay tax only on your gross rental income over the £4,250 limit, but you can't make any deductions for expenses. It is normally beneficial to do this only when your expenses are less than £4,250 (or £2,125 if shared). If you have more expenses to offset, it may be better to opt out of rent-a-room and be taxed as you would with any other rental income.

Holiday lettings

Your property is treated as holiday accommodation if it is available for letting to the public on a commercial basis for at least 140 days during each 12-month period. It must actually be let for 70 or more of these days, and during at least seven of the 12 months no tenant may occupy it for more than 31 days in one go.

If you let furnished holiday accommodation commercially on a regular basis, you may be allowed some of the concessions given to business income. For this to apply, the lettings must always fulfil the rules above and you must agree this with your tax office.

Your home as a business

The third category of rental income is from rooms you let in your home as a business – a small hotel, guest house or bed and breakfast establishment.

The Revenue treats this as business income (rather than rental income) if you provide services such as meals and laundry that are beyond those normally offered by a landlord.

On your self-assessment tax return, enter income from a bed and breakfast or guest house on the supplementary pages for self-employment, not on the land and property supplementary pages. Interestingly, you can opt to claim rent-a-room relief if you own this type of establishment see Inland Revenue helpsheet IR223 *Rent-a-room for traders*.

Better off with rent-a-room

Bill charges his lodger Ben rent of £400 a month to share his house. This is more than the rent-a-room relief allowed, so Bill has a choice of how to deal with the income.

If he stays in the rent-a room scheme, £4,250 of Ben's rent will be tax-free. That leaves £550 to be taxed at Bill's top rate of tax, which is 22 per cent. So he pays tax of £121 on Ben's rent for the year.

Alternatively, he can opt out of the rent-a-room scheme and have the whole lot treated as ordinary rental income, which means he can deduct relevant expenses and have only the 'profit' taxed. However, at the most, the expenses Bill could claim against the rent would come to about £1,000 for the year, which when deducted from the total rent received would leave him with a profit of £3,800 and a much bigger tax bill of £836 (22 per cent of £3,800).

Any other rental income

Any other income you receive from letting houses, flats or land you don't live in yourself falls into this category. The same rules apply whether you let out one property or many, and whether the property is furnished or unfurnished. Overseas property you let out is broadly treated in the same way as income from property in the UK, but you must keep separate records and declare any income received from overseas property on the foreign income pages of the tax return – not the land and property pages.

MORE HELP

INLAND REVENUE BOOKLETS

IR87 Letting and your home

IR150 Taxation of rents. A guide to property income

ALLOWABLE EXPENSES

You can offset certain expenses against rental income when you work out your profits, as long as they are wholly and exclusively incurred as part of renting out your property. If you let only part of your home, or let it out for only part of each year, you have to agree with the Inland Revenue the proportion of these expenses you can claim.

The most common allowable expenses are:

- water rates, ground rents and council tax
- normal repairs and decoration, but not improvements or additions
- wear and tear (see right)
- bills such as gas and electricity
- management expenses, such as phone bills, accountants' fees and the cost of rent collection
- legal fees when you renew a tenancy agreement
- insurance valuations and premiums
- estate agents' or letting agencies' fees and the cost of advertising for tenants
- the cost of services you provide, including the wages of cleaners and gardeners
- the cost of preparing an inventory
- interest on any mortgage on the property (but not repayment of capital)

Wear and tear

If property you let out is fully furnished, you can claim for wear and tear of furnishings such as cookers and carpets. This can be calculated on either a 'renewals' basis or 'wear and tear' basis. You can choose which basis to use, but you must stick to it for as long as you let that property.

With the renewals basis, you can claim the cost of any items replaced (excluding any extra items you buy and improvements you make).

Alternatively, the wear and tear basis lets you claim 10 per cent of the rent, less council tax, water rates and other services you pay which would usually be paid by a tenant.

The possible advantages of the 10 per cent wear and tear allowance over the renewals allowance is that it is simple to calculate and you get a deduction each year.

Mortgage interest

If you have a mortgage on the property you let out, you can deduct all the interest you pay from the rent you receive as an allowable expense. If this leaves you with a minus figure, you have effectively made a loss, which you can carry forward and offset against future rental income.

Always tell your mortgage lender and insurers if you let rooms in your home, or let out your whole home. Failure to do so could breach the contractual agreements you have with both.

TAX CREDITS

The working families tax credit (WFTC) and disabled person's tax credit (DPTC) are designed to help families and disabled people on lower incomes.

These tax credits are administered by the Inland Revenue instead of through the social security system.

WORKING FAMILIES

WFTC is available to couples (married or unmarried) or single parents who have one or more children under 16 (or under 19 if in full-time education) living with them.

To be eligible, you (or your partner) must also work 16 hours a week or more and be resident in the UK and entitled to work here. Currently, WFTC is made up of:

- a basic tax credit of £59
- an additional £11.45 if one partner works at least 30 hours a week
- a tax credit for each child: £26 from birth, and £26.75 from the September after their 16th birthday until the day before they are 19
- a childcare tax credit of up to 70 per cent of eligible childcare costs to a maximum of £135 a week for one child, or £200 a week for two or more children
- an extra £30 per week for a child with a disability
- an enhanced disability payment (see right).

However, WFTC is reduced by 55p for each £1 of net income above £92.90. This is your earnings less tax, National Insurance, and half of any pension contributions.

DISABLED PERSON'S

DPTC works in a similar way to WFTC but you do not have to be looking after children to receive it – although you get more if you do. You qualify if an illness or disability puts you at a disadvantage in getting a job and you work at least 16 hours a week. You must also receive a qualifying disability benefit, or have received it up to 182 days prior to the date of your application for the tax credit. Just like WFTC you must be resident in the UK and entitled to work here.

Currently DPTC consists of:

- a basic weekly credit of £61.05 for single people or £91.25 for a couple or lone parent
- an extra £11.45 if you work at least 30 hours a week
- a tax credit for each child in the family, at the same rates as WFTC
- an extra £30 for each child you have who receives disability living allowance or is registered blind (or has been registered in the last 28 weeks)
- a childcare credit worth the same as the WFTC childcare element
- an enhanced disability payment (see below).

DPTC is reduced by 55p for each £1 of net income above £72.25 for a single person. For a couple or lone parent, DPTC is reduced by 55p for each £1 of income over £92.90.

Enhanced disability payment

A new tax credit was introduced from April 2001 for people claiming either WFTC or DPTC who are receiving higher-rate disability living allowance for care. The payment is £11.05 a week for a single person (so paid only with DPTC), £16 a week if paid to a lone parent or couple, or £41.05 a week if paid on behalf of a child. The child's payment includes the disabled child tax credit.

YOUR SAVINGS

You are eligible for tax credits only if your savings are under £8,000 (WFTC) or £16,000 (DPTC). But savings above £3,000 are taken into account in assessing your income. It is assumed you earn £1 a week from each £250 of savings above £3,000. So someone with £5,000 would be assessed as receiving £8 a week £5,000 – £3,000 ÷ £250.

RECEIVING CREDITS

Application forms are available from benefit agency offices, job centres, post offices, citizens' advice bureaux, tax enquiry centres or the tax credit office.

Employees now receive tax credits through the PAYE system with their wages (as a reduction in tax owed or as an extra payment on top of their wages). The Inland Revenue pays tax credits for the self-employed direct to their bank accounts.

Couples can choose which partner receives WFTC (it can't be split between them). You can't transfer DPTC (even the childcare element) to anyone.

HOW WORKING FAMILIES TAX CREDIT WORKS

Sam is a lone parent who earns £200 a week (after tax and National Insurance) and works fewer than 30 hours a week. Childcare for her son, Ben, aged six, costs £60 a week. She has no savings.

Basic tax credit **£59**
Under-16 tax credit for one child **£26**
Childcare tax credit (70% of £60) **£42**
Total tax credits **£127**
Less 55% of £107.10 (income above £92.90) **£58.90**
Total WFTC **£68.10**
Total income (£200 + £68.10) **£268.10**

MORE HELP

INLAND REVENUE BOOKLETS

WFTC/BK1 Your guide to working families tax credit

DPTC/BK1 Your guide to disabled person's tax credit

INLAND REVENUE HELPLINES

Working families tax credit
✆ 0845 6095000

Disabled person's tax credit
✆ 0845 6055858
Northern Ireland ✆ 08456 097000

SAVINGS AND INVESTMENTS

Taxable, taxed and tax free... Different savings products have different tax rules. This chapter explains the current rules and covers the different options for investing tax free.

Since April 1999, the starting rate of tax – 10 per cent – has applied to interest on savings such as bank and building society accounts. This affects people whose earned income or pension income does not take them into the basic-rate tax band. The level of the starting rate band was increased in this year's budget from £1,520 to £1,880.

So, from 6 April 2001, the first £1,880 of taxable income (after any personal allowances) is taxed at 10 per cent. Non-savings income that falls into the basic-rate tax band (between £1,881 and £29,400) is taxed at 22 per cent. Savings income that falls within this band, however, is taxed at 20 per cent. Any income in the higher-rate band (over £29,400) is taxed at 40 per cent, whatever type of income it is.

Income from savings or investments can be taxed in three different ways – taxable but paid gross (that is, paid in full, without tax deducted), taxed and tax free. Each type is explained in this chapter, and the table on p22 shows how a range of investments are taxed.

TAXABLE BUT PAID GROSS

Although income on these types of investments is paid gross (that is, with no tax deducted), you have to declare it and pay tax, unless you're a non-taxpayer.

National Savings

Interest on Capital Bonds, Income Bonds, Investment Account and Pensioners' Bonds are all paid gross. The same is true for the Ordinary Account (but see p23).

Gilts

Gilts (short for gilt-edged securities – another name for government stocks) acquired since 6 April 1998 pay interest gross but you can ask to have it paid net of tax. Gilts bought before that date continue to pay interest net, unless you choose to be paid gross. If you buy or sell gilts you may come within the accrued income scheme. If so, part of the price may be taxable as the equivalent of interest (usually when you sell). But you may receive tax relief on the first interest payment because of interest accrued and reflected in the price when you bought the stock. This also applies to other interest-bearing securities such as local authority bonds, corporate bonds and permanent interest-bearing shares issued by building societies (PIBs). However, the accrued income scheme doesn't apply if the nominal or face value of all accrued income scheme securities held doesn't exceed £5,000 at any time.

Offshore accounts

Offshore accounts and investment funds, such as those based in Dublin or the Channel Islands, pay income gross but this doesn't mean it's tax free. If you are UK resident then you are normally charged on the full amount of foreign income arising abroad, whether it is brought into the UK or not. Declare this type of income on your tax return using the special pages for foreign income.

TAXED

Tax on income from certain of these investments or savings (for example, building society and bank interest) is usually deducted at source by the provider, who pays it to the Inland Revenue. Basic-rate taxpayers have no further liability. Starting-rate taxpayers may be able to claim back half of the tax, and non-taxpayers all of the tax (but see 'Shares and investments', p22). If you are a non-taxpayer you can also register to have this income paid gross – you'll need form R85, available from your bank or building society.

However, if, after totalling all your income (including the before-tax value of investment income), you become liable for tax at the higher rate, you have to pay extra tax by declaring it on your tax return or through your PAYE code.

LIFE INSURANCE

There are two types of life insurance policy, and the income from each is treated slightly differently.

Qualifying policies

Most regular premium policies, such as whole-of-life insurance and most endowment policies lasting ten years or more, are qualifying policies. Provided you keep them for at least ten ▶

years (or, if less, three quarters of their term), you pay no tax on the proceeds – the provider has already paid tax that you can't reclaim (equivalent to the basic rate) on the underlying investment. If you stop the policy before then, you may have to pay additional tax, but only if you make a gain on the policy.

Non-qualifying policies

Providers also pay tax on underlying investments in non-qualifying life policies such as single-premium investment bonds. This covers your liability to basic-rate tax. However, higher-rate taxpayers pay 18 per cent more tax (the difference between basic- and higher-rate tax) when they cash in the policy or if they make a gain by withdrawing more than 5 per cent of the original investment in a tax year.

HOW INCOME IS TAXED IF YOU'RE A UK RESIDENT

	Tax status			
	Taxable	Taxed	Tax free	Notes
Accounts (held in £ or foreign currency) at a UK branch of a bank or building society		✓		see[1]
Accounts at an offshore (eg Jersey, Isle of Man) branch of a UK or foreign bank or building society	✓			
Annuities		✓		see[1,2]
British government stocks (gilts) on the National Savings Stock Register	✓			see[3]
Other British government stocks		✓		see[3]
Co-operative Society deposits	✓			
Corporate bonds, debentures, loan stock and other fixed-income investments		✓		see[4]
Friendly society tax-exempt plans (eg baby bonds)			✓	
Interest from private individuals	✓			
Interest on distributions under a will		✓		
Isas			✓	
Loans to foreign governments		✓		see[5]
Local authority loans		✓		see[1]
National Savings Ordinary Account: ● first £70 (£140 joint account) ● remainder	✓		✓	
National Savings Certificates			✓	
National Savings Children's Bonus Bonds			✓	
National Savings First Option Bonds		✓		
National Savings: other accounts and bonds	✓			
Offshore managed funds	✓			
Open-ended investment company distributions		✓		see[6]
Permanent interest-bearing shares (PIBS)		✓		see[4]
Personal equity plans (Peps)			✓	
Premium Bond prizes			✓	
Proceeds from qualifying life insurance policies (usually)			✓	see[7]
Save-as-you-earn accounts			✓	
Share dividends from UK companies		✓		see[6]
Tax exempt special savings accounts (Tessas)			✓	see[8]
Tax rebate interest			✓	
Traded options				see[9]
Trusts and settlements: payments to beneficiaries		✓		
Unit trust distributions		✓		see[6]
War loans	✓			see[3]

1 Non-taxpayers can receive this gross
2 See 'Annuities', left
3 No capital gains tax to pay
4 No capital gains tax if they count as qualifying corporate bonds
5 If in foreign currency, may be received gross but taxable
6 Profits on sale taxed as capital gains
7 But insurance company has paid tax which cannot be reclaimed.
With non-qualifying policies, higher-rate taxpayers have to pay extra tax
8 Tessas must be kept for five years
9 Taxed as capital gains unless linked to gilts or qualifying corporate bonds

ANNUITIES

Apart from any tax-free lump sum you take when you retire, your pension fund is normally used to buy a compulsory purchase annuity. All of the income from these is subject to tax and is usually paid net of tax. If you buy an annuity with non-pension savings (or with your pension lump sum), part of your income from this annuity is treated as a refund of your initial outlay and is free of tax.

SHARES AND INVESTMENTS

Shares, investment trusts, open-ended investment companies (Oeics), and unit trusts will often pay you an income.

The Inland Revenue treats dividends from UK shares and distributions from Oeics and unit trusts as being paid net of tax at 10 per cent. This tax credit should be shown on your dividend or distribution voucher. Starting- and basic-rate taxpayers pay no more tax. Higher-rate taxpayers pay a further 32.5 per cent. Non-taxpayers can't reclaim this tax. If you switch your investment into an Isa (see right), the tax can be reclaimed by the Isa manager at least until 2004, whatever your tax status.

You can often choose to reinvest your income, in which case it is treated in the same way as if you received the dividend as cash.

When you invest in an Oeic or unit trust, though, part of the price may reflect income that has accumulated in the fund. This 'equalisation payment' is refunded to you as part of the first distribution you receive. You do not have to declare equalisation payments on your tax return as they are treated as returns of capital and aren't taxable. They should be deducted from your initial investment for capital gains tax purposes.

TAX-FREE INVESTMENTS

The main tax-free investments that you can have are individual savings accounts (Isas) and certain National Savings schemes.

You can no longer open a new Pep or Tessa. You can, though, transfer existing Peps and Tessas from one manager to another.

You can't pay more money into a Pep or transfer it to an Isa. But if you have a current Tessa, you can continue to contribute to it (up to £1,800 each tax year) until the end of the five-year term is reached. A maturing Tessa can be transferred to an Isa without affecting your other Isa allowances. For this reason, such Isas are known as Tessa-only Isas.

INVESTING IN ISAS

The main news for savers is that the higher investment limits into individual savings accounts (Isas) have been extended until the tax year ending 5 April 2006. So you can pay in up to £7,000 each year for the next five tax years. The limit on how much you can invest in an Isa was due to fall from a maximum of £7,000 to a maximum of £5,000 in this tax year.

The three types of Isa investment are: cash (savings accounts with banks or building societies); share-based investments (shares, unit trusts, and so on), and life insurance (normally

investments into life offices' funds such as with-profit funds). You can choose to have all the components in one Isa, known as a maxi Isa (although few offer all three or even two components), or each part can be a separate mini Isa which can be with different providers.

You can't invest in a maxi and a mini in the same tax year, or open two Isas of the same type – say, two mini cash Isas. The annual limits for mini Isas are £3,000 cash, £3,000 stocks and shares and £1,000 life insurance. These apply to what you pay in, not your balance. So if you put £3,000 in a mini cash Isa, you have used up your allowance – if you withdraw £100, you can't pay it back in later during the same tax year.

Income and gains from an investment in an Isa are free of income and capital gains tax. In the share-based component, the Isa manager can reclaim the tax on dividends, but only until 5 April 2004. After that, dividends on Isas will attract tax, which the Isa provider must pay. However, there will still be no personal liability to income tax or capital gains tax for Isa holders.

Isas are available to UK residents and the age limit has now been dropped so anyone aged 16 or over on 6 April 2001 can take out an Isa.

Isas and shares

You can move existing share-based investments into a stocks and shares Isa where they will be free of income and capital gains tax (but see above about tax treatment after April 2004), although they usually have to be sold then re-purchased within the Isa.

The shelter of an Isa is worthwhile for unit trusts and Oeics, or if you hold shares in a nominee account, as the charges are often no different whether you hold them in an Isa or not. Isas investing in shares are also valuable if you are a higher-rate taxpayer or are likely to use up your capital gains tax allowance.

NATIONAL SAVINGS

Half the National Savings schemes available are tax free. These include the National Savings cash Isa and the investments detailed here. For current interest rates, see 'Savings monitor', published each month in *Which?*.

Certificates

The two types of certificate, fixed-interest and index-linked, are both tax free. The minimum purchase for both is £100. New issues of certificates come out fairly frequently and the most you can buy of each issue is £10,000. You can also reinvest, with no limit, the proceeds of matured certificates from previous issues.

Fixed-interest certificates pay a guaranteed income over five years. The return on index-linked certificates is a fixed percentage on top of the annual increase in inflation, as measured by the retail prices index.

Children's Bonus Bonds

Anyone over 16 can buy these for children aged under 16. They are sold in units of £25 and can be held for up to five years. They can be cashed in with one month's notice but pay a bonus if held for five years. You can reinvest Children's Bonus Bonds after five years but they mature at the holder's 21st birthday and no further returns are earned after that time. Returns are tax free and don't affect parents' tax liability, even if they pay for the bonds. The maximum holding of the current issue is £1,000 a child, in addition to holdings of earlier issues.

Ordinary Account

Although the rates of interest on the account are low (as at 1 April 2001, 1.75 to 1.85 per cent depending on the amount invested), the first £70 of interest (£140 with joint accounts) is free from tax, and it offers instant access from any post office for small withdrawals. Any interest above the tax-free limit is taxable, and there is a maximum holding of £10,000. Interest is so low, however, that you're probably better off with an ordinary taxable savings account.

Premium Bonds

These do not pay interest, but are included in a monthly prize draw after you've held them for one month. Winnings are free of income and capital gains tax. You can cash in the bonds at any time at face value.

FRIENDLY SOCIETY PLANS

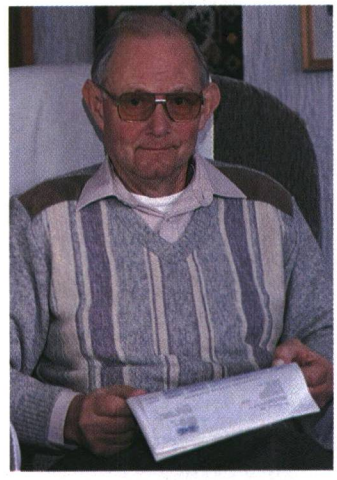
Friendly societies offer tax-free insurance plans that must last at least ten years. Unlike other insurance policies, the society pays no tax on the underlying investment, but charges can be high, especially in the early years. Some societies market their plans to people investing for children up to age 18 or 21. You can invest up to £270 a year if paid in a lump sum, or £300 a year if you pay monthly.

MORE HELP

INLAND REVENUE LEAFLETS

IR68 Accrued income scheme
IR110 A guide for people with savings
ISA1 The answers on Isas

Interest payment incurs tax



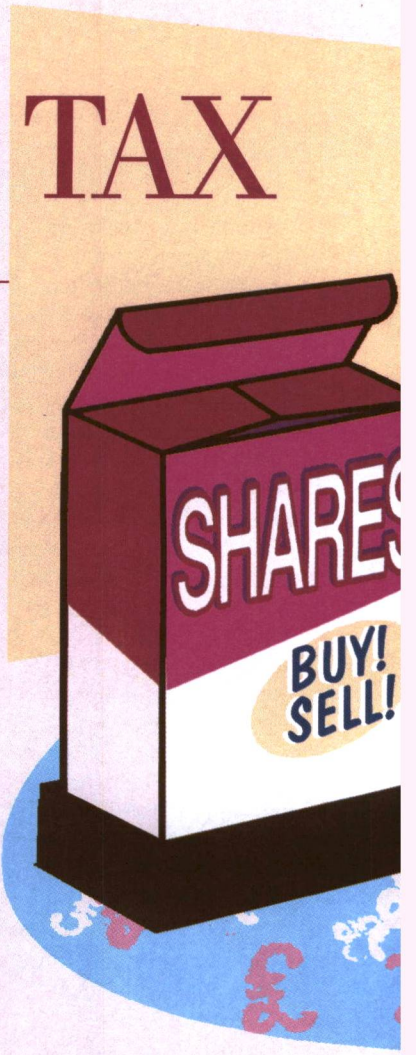
When Ralph Goringe took out a three-year guaranteed interest bond with Halifax, he registered to receive the interest gross as he is a non-taxpayer. He had been careful to check that the yearly interest from the bond, when added to his other income, wouldn't take him over his personal allowance.

However, what Ralph wasn't told was that Halifax declares all the interest earned on the bond at the end of the term, rather than yearly. This meant that the total interest was added to Ralph's other income in one tax year (instead of over three), pushing his income for that year over his personal allowance and giving rise to a tax demand of £216.20.

Halifax told us it has to do it this way – but Ralph has a similar bond with Cheltenham & Gloucester where the interest is declared yearly. Ralph wrote to us to tell us about his experience so that other non-taxpayers wouldn't get caught out.

We're going to look into this further for Ralph, but in the meantime, if you are a non-taxpayer and considering this type of investment, check with your provider when it declares interest – otherwise you could find yourself with an unexpected tax demand, like Ralph did.

CAPITAL GAINS TAX



Whenever you dispose of an asset, for example by selling it or giving it away, you may be liable for capital gains tax.

Basically, an asset is anything you own. There's no capital gains tax (CGT) to pay on your estate when you die, but there may be inheritance tax (see 'Gifts and bequests', p33).

HOW MUCH TAX?

Tax is based on the increase in value of the asset during the time you owned it. This is calculated by taking the final value of the asset when you disposed of it and subtracting the initial value when you acquired it, along with any allowable expenses.

In general, only gains or losses since 31 March 1982 are taken into account, and some gains are tax free. The first slice of capital gains (£7,500 in the 2001-2002 tax year) is also free of tax.

Your taxable gains are treated as the top slice of your income. The rate of tax you pay depends on which tax band your taxable gains plus your other taxable income falls into. For 2001-2002, if your total taxable income and gains are below £1,880, you pay 10 per cent tax; on gains that fall in the basic-rate tax band (between £1,881 and £29,400) you pay 20 per cent tax; and for gains that fall into the higher-rate band (over £29,400) you pay 40 per cent.

LOSSES

If you make a loss on the sale or transfer of an asset, you must offset it against any gains you make in the same year.

If after using your current year losses you still have gains above the tax-free slice, you must use losses made in any previous years to reduce your gains to the level of the tax-free amount. You can't offset losses on assets or transfers that are exempt from CGT, such as Peps, Isas or transfers to your husband or wife.

UNUSED LOSSES

Losses that you haven't used against gains can be carried forward indefinitely to future years, irrespective of when you made the loss.

Since 1996-1997 you must notify the Revenue of losses if you intend to carry them forward to use in future years. You have just under six years from the end of the tax year in which you make the loss to do this – so until 31 January 2008 for losses made in 2001-2002.

Losses made before 6 April 1996 don't have to be notified to the Revenue within a certain time.

TAX-FREE GAINS

The main assets and transactions that are free of CGT, subject to certain conditions, are:

- gifts between husband and wife
- your only or main home (but see p26)
- private motor cars
- betting, lottery or pools winnings
- British Government stocks (gilts), qualifying company loan stock and building society permanent interest-bearing shares (PIBS)
- most cashbacks
- gifts to charities and national heritage bodies
- shares in a Venture Capital Trust
- shares held through an Enterprise Investment Scheme (or the earlier Business Enterprise Scheme)
- proceeds from life insurance policies, unless they're bought second-hand
- compensation for personal injury
- compensation because you were mis-sold a personal pension between 29 April 1988 and 30 June 1994
- National Savings, Peps and Isas
- personal possessions with a useful life of 50 years or less from the date you acquired them. For possessions that have a longer life, see Inland Revenue helpsheet IR293 *Chattels and CGT*.

REDUCING YOUR BILL

The rules for calculating capital gains tax have changed several times over the years, the most radical change being the abolition of indexation allowance for periods after April 1998 and the introduction of taper relief.

Indexation allowance

This applies to assets acquired before 1 April 1998. It means that you are not taxed on gains in line with inflation between March 1982 and April 1998.

Your initial value and allowable expenses are linked to the retail price index (RPI) and increased in line with the index. The effect is that your taxable gain is reduced or eliminated. However, you cannot use indexation to create or increase a loss. The

GLOSSARY

Allowance expense Some costs of acquiring or disposing of assets (such as commission, legal fees, stamp duty and advertising) can be deducted from your gains.

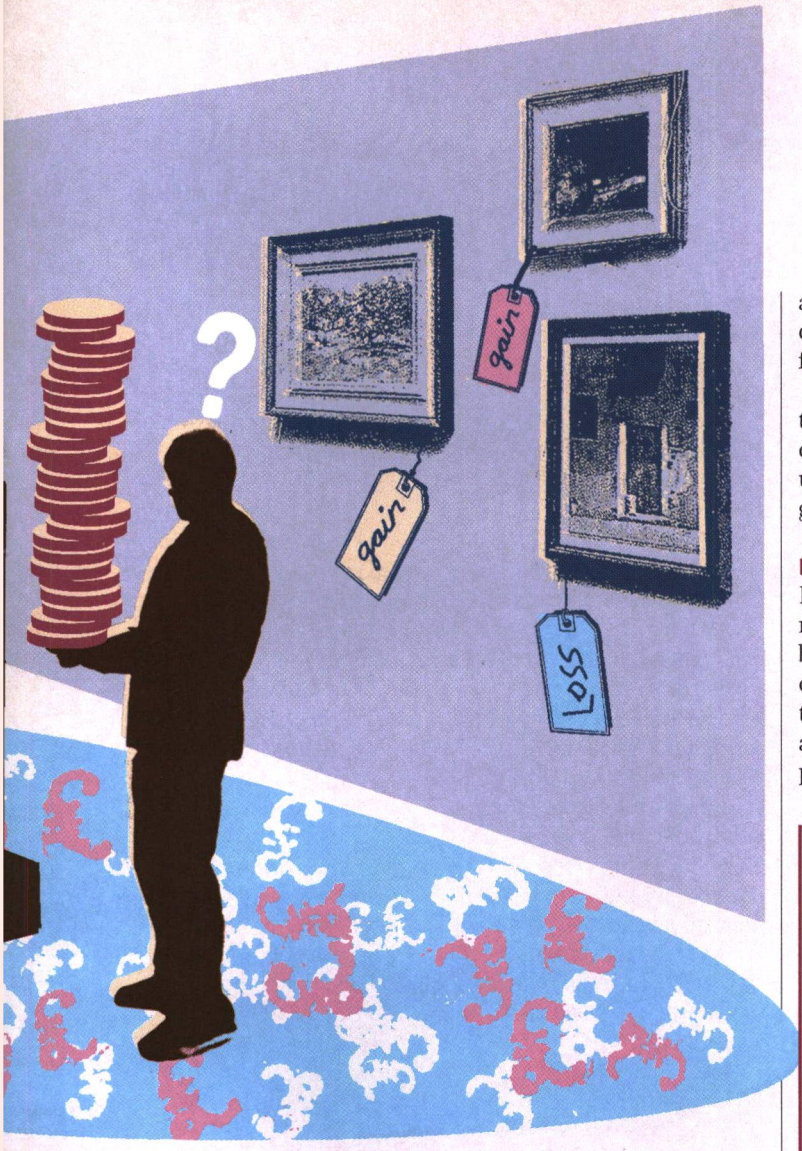
Chargeable gain This is the amount of gain before applying the tax-free slice, losses or any taper relief.

Final value This is an asset's sale price or market value at the time you give it away. If you sell for less than the market value, the final value is usually the market value.

Initial value The price paid for an asset, or its market value when you received it (you may need to agree this with your tax office).

Indexation An allowance that stops you paying tax on increases in value caused by inflation. It applies only to increases up to April 1998.

Taper relief A tax relief that reduces how much of the gain you pay tax on, depending on how long you've held the asset after 5 April 1998.



Which? Tax Return Guide 2001 (published in April) contains a CGT calculator and a table of indexation allowances (pages 31 and 32).

TAPER RELIEF

Taper relief reduces the chargeable gain depending upon the length of the time you've owned the asset after 5 April 1998. Within limits, the longer the asset is held, the smaller the proportion of any gain you pay tax on – this is the equivalent of reducing the level of CGT you pay (see the table, right).

The amount of taper relief depends on whether an asset has been a business asset or not – taper relief is more generous for business assets.

You must own a non-business asset for at least three years and a business asset for at least one year after 5 April 1998 before taper relief reduces your tax bill. However, non-business assets held before 17 March 1998 (budget day) have an extra year added to the period of ownership that qualifies for taper relief.

This means non-business assets held before 17 March 1998 and disposed of on or after 6 April 2001 have four years' qualifying ownership and only 90 per cent of the gain on these assets will therefore be liable to tax.

Losses and taper relief

Before you apply taper relief, losses from the current tax year and unused losses from previous tax years must be offset against your gains. You allocate losses to gains that qualify for the least amount of taper relief first – this ensures you maximise your taper relief.

Losses made in the current tax year must be applied against the gain before any losses brought forward from previous years. If a chargeable gain remains, unused losses from previous years must be applied to the gain, but only down to the level of the tax-free slice.

In practice, you will get the benefit of taper relief only if the remaining untapered chargeable gain is greater than the tax-free slice.

BUSINESS ASSETS

For the purposes of taper relief, a business asset is broadly defined as an asset, other than shares or securities, that you use to carry out a trade, whether alone, in partnership or through your qualifying company. This includes assets held by an employee for their work.

The March 2000 and 2001 budgets extended business taper relief, and the following shareholdings now also count as business assets:

- all shareholdings in unquoted trading companies
- all shareholdings held by employees in quoted trading and non-trading companies (provided they do not hold more than 10 per cent interest in the company
- all shareholdings in a quoted

HOW TAPER RELIEF WORKS

If you bought shares in 1987 that you sold in July 2001 for a profit of £1,404 (after deducting indexation allowance up to April 1998 and any allowable losses), this is how taper relief would apply:

Your net gain	**£1,404**
Complete number of years asset held after 5 April 1998 (including extra year as asset was held before 17 March 1998)	**4 years**
Percentage of gain chargeable for non-business assets (with qualifying period of three years)	**90%**
Net chargeable gain is 90 per cent of £1,404	**£1,263**

If you'd used up your capital gains tax-free slice, you'd pay £126.30 capital gains tax on this gain if you were a starting-rate taxpayer, £252.60 if you were a basic-rate taxpayer, and £505.20 if you were a higher-rate taxpayer. This is equivalent to paying capital gains tax at 18 per cent for basic-rate taxpayers (36 per cent for higher-rate taxpayers) on the original gain of £1,404.

Gains on business assets			Gains on non-business assets	
Complete years after 5 April 1998 that asset was held	Percentage of gain that is chargeable – the taper (%)	Equivalent CGT rate for higher-/basic-rate taxpayers – 40/20% times the taper	Percentage of gain that is chargeable – the taper (%)	Equivalent CGT rate for higher-/basic-rate taxpayers – 40/20% times the taper
0	100	40/20	100	40/20
1	87.5	35/17.5	100	40/20
2	75	30/15	100	40/20
3	50	20/10	95	38/19
4	25	10/5	90	36/18
5	25	10/5	85	34/17
6	25	10/5	80	32/16
7	25	10/5	75	30/15
8	25	10/5	70	28/14
9	25	10/5	65	26/13
10+	25	10/5	60	24/12

POOLING

Shares of the same type in the same company acquired after 5 April 1982 and before 6 April 1998 are normally pooled.

For tax purposes, the cost of shares in the pool is the average cost of acquiring them. If you bought 200 shares for £500, 200 for £600, and 200 for £700, the average is £1,800 divided by 600 = £3 a share.

You have a separate pool for each type of share you hold in a company. Work out indexation separately on each batch of shares every time you make an addition or disposal from the pool. Shares acquired after 5 April 1965 and before 6 April 1982 are pooled together in the same way.

trading company where the holder is not an employee but can exercise at least 5 per cent of the voting rights.

If an asset has been used as a business and non-business asset, the gain will generally be split pro rata between the two taper relief rates.

SPECIAL CASES

There are special rules you need to watch out for when you sell or give away shares, your own business, a home, or assets you've owned since 1982. We've explained the main ones here.

Assets owned on 31 March 1982

For these assets, the initial value is normally the market value on 31 March 1982, and not the original cost. You also usually ignore any expenses before 31 March 1982. Indexation applies to the March 1982 value and to expenses incurred after that. For more information, see Inland Revenue helpsheet IR280 *Rebasing assets held at 31 March 1982*.

CGT on shares

Shares or units in a unit trust or Oeic held outside Isas (and Peps) are liable for CGT when you sell them if they have increased in value since you bought them. Shares or units of the same type in the same company or unit trust used to be pooled (see box left). Taper relief means you can't pool shares or units you buy on or after 6 April 1998. Instead, each purchase has to be recorded separately from other purchases – even if they are in the same company.

If you have acquired shares of the same type in the same company at different times, the Revenue has special rules for deciding what order the shares are disposed in. For more information, see Inland Revenue helpsheet IR284 *Shares and capital gains tax*.

Rights and bonus issues

Extra shares you receive under a rights or bonus issue count as belonging to the same holding as the original shares to which they relate. Rights or bonus issues for shares issued after 6 April 1998 are treated as having the same acquisition date and purchase cost as the original shares.

This rule doesn't apply to 'scrip' dividends – dividends paid in the form of shares rather than cash. These are treated as new acquisitions at the dividend date.

Takeovers and mergers

If you exchange your shares for new shares due to a takeover or merger, it won't normally count as a disposal, so there will be no tax at that time. But if you exchange your old shares for new shares and cash, you're assumed to have disposed of a proportion of your old shares (the percentage of the exchange represented by cash). For further information, see Inland Revenue helpsheet IR285 *Share reorganisations and takeovers*.

CGT and business

If you're 50 or over, or if you have to retire before then through ill health, you may qualify for retirement relief. This means that all or part of your gains made from the sale of your business may be tax free. This may also apply if you sell shares in a trading company where you are a full-time director or employee and can exercise at least 5 per cent of the voting rights.

Currently you can apply both retirement relief and taper relief to your gains. However, retirement relief is gradually being phased out and won't apply to business disposals after 6 April 2003. From then only taper relief will apply. However, as retirement relief reduces, taper relief increases, so you won't necessarily be any worse off.

CGT on your home

If you've lived in the whole of your only or main home since you acquired it, CGT won't usually affect you when you come to sell unless:

- you converted your home into a number of self-contained flats and sold them, or built a second home in your garden and then sold it
- you use part of your home exclusively for business, or you let part of it
- you were away from your home for more than three years in total
- the home is one of a series that you bought in order to make money
- you were away for less than three years but didn't use it as your main home at some stage before and after.

Absences in the last three years before disposal are usually exempt, as are some first-year absences and those that are work-related.

You may not get full exemption for your garden if, including the house, it's over half a hectare. See Inland Revenue helpsheet IR283 *Private residence relief*.

More than one home

If you own more than one home, you may be able to choose which to treat as your tax-free main one. Preferably, choose the one on which you think you'll make the largest gain – it doesn't have to be the one where you live most of the time. You must tell your tax office of the choice within two years of owning two homes. You can change your choice and specify the date the change should take effect, as long as this isn't more than two years before the date you notify your tax office of the change.

DEFERRAL RELIEF

You can put off paying some or all of your capital gains tax when you make a disposal if you reinvest all or part of the gain in newly issued shares in an Enterprise Investment Scheme company or a Venture Capital Trust.

The rules for deferral relief are complicated. For more information, see Inland Revenue helpsheets IR297 *Enterprise Investment Scheme and CGT*, IR298 *Venture Capital Trusts and CGT*, and IR137 *Enterprise Investment Scheme*.

MORE HELP

INLAND REVENUE BOOKLETS

CGT1 Capital gains tax: an introduction
IR137 Enterprise Investment Scheme

INLAND REVENUE HELPSHEETS

IR280 Rebasing – assets held at 31 March 1982
IR284 Shares and capital gains tax
IR285 Share reorganisations and takeovers
IR287 Employee share schemes
IR289 Retirement relief and CGT
IR297 Enterprise Investment Scheme and CGT
IR298 Venture Capital Trusts and CGT

SAVING FOR YOUR RETIREMENT

The pensions world is currently going through the biggest shake-up it's had in years with the introduction of new stakeholder pensions in April 2001. Mostly it's good news for the consumer, with high charges becoming a thing of the past.

Generally, pension plans remain a tax-efficient way to save for retirement. You get tax relief on your contributions, and your money grows largely tax free. Many plans let you take part of the proceeds as a tax-free lump sum.

In this chapter we give a rundown of private pensions. 'Tax for older people', p16, tells you what you can expect to receive from the state.

YOUR PENSION CHOICES

Currently there are two main options. If your employer offers a pension scheme, you can join that. If it doesn't (or if for some reason you don't want to join) or you're self-employed, you can start a personal pension – including a personal stakeholder scheme.

EMPLOYERS' SCHEMES

There are many different types of pension scheme that fall under the heading of employers' schemes. However, the information that follows relates to traditional employer pension schemes, known as occupational pension schemes. Employers can also offer group personal pension schemes and access to a stakeholder scheme, and these are dealt with on p28. It is also now possible for employers' money-purchase occupational pension schemes to opt in to the new tax regime brought about by the introduction of stakeholder pensions (see p28). Those schemes are covered by the rules related to personal pensions rather than the rules mentioned here.

Traditional occupational schemes

If an employer offers a traditional occupational pension scheme it must contribute to it. Usually employees are also required to pay in – between 3 and 6 per cent of your salary is fairly typical. Some schemes don't require contributions from employees (these are known as non-contributory schemes). You can pay in up to 15 per cent of your annual earnings (including the taxable value of most fringe benefits, such as a company car) each year and still get tax relief. Employers' contributions don't count towards this limit and don't count as a taxable fringe benefit. You receive tax relief by your employer deducting contributions from your pay before working out your tax.

The pension you end up with depends on limits laid down by the Inland Revenue, the rules that apply to your scheme and the type of scheme that your employer runs.

Although you receive tax relief on your contributions, you have to pay tax on your eventual pension. However, at retirement you can take part of the pension fund as a tax-free lump sum.

Final-salary schemes

These schemes pay a pension based on a proportion of your earnings at or near to your retirement. The amount you get depends on your length of service with the employer or the number of years you've been in the scheme.

Money-purchase schemes

The contributions you and your employer make are invested. When you retire, you use the money that has built up to buy a pension income. This is usually done by buying an annuity, which pays a regular income until you die.

Annuity rates vary, so the pension you get after retirement depends on the value of your pension fund and the annuity rates applicable at the time you take your pension.

Hybrid schemes

Hybrid schemes mix elements from both final-salary and money-purchase schemes. Check the scheme's rules to find out how it calculates your benefits.

Topping up your pension

To boost the pension you get from your employer, you can pay additional voluntary contributions (AVCs), either into the AVC scheme attached to your employer's pension scheme or by arranging a free-standing scheme (FSAVC) with an insurance company. However, FSAVCs have much higher charges than in-house AVCs and can be poor value. The financial services regulator, the Financial Services Authority (FSA), has instigated a review into mis-selling of certain FSAVCs and ▶

issued a factsheet (phone 0845 6061234 or look up www.fsa.gov.uk).

AVC schemes (whether in-house or free-standing) can only provide a pension. You can't take a tax-free lump sum from these schemes unless the scheme started before 8 April 1987. However, from April 2001, if you earn less than £30,000 a year and you are not a controlling director, instead of putting AVCs into your pension scheme or an FSAVC you can pay them into a stakeholder scheme instead. Unlike most AVC schemes, you can take part of your stakeholder fund as a tax-free lump sum. The situation is different with added-years schemes (see below).

Added-years schemes

These AVCs, only available through final-salary schemes, give you the option to 'buy' extra years' service in your pension scheme. This automatically boosts all your benefits, including the tax-free lump sum. It's a good option if you won't have enough years' service to get the maximum entitlement at retirement.

Group personal pensions

These plans have the same rules as individual personal pension plans, but are run as a collective scheme with one pension provider. Your employer chooses the provider and pays premiums to it direct from your salary.

Because the provider is collecting one sum for all employees' contributions direct from the employer, lower charges can be negotiated, so a personal pension taken out as a part of a group scheme will often have lower charges than a plan you buy direct yourself.

Despite this, many personal pensions, even as part of a group scheme, still have higher charges than the new stakeholder pensions. Your employer does not have to offer access to a stakeholder scheme through your workplace if it runs an occupational scheme or has arranged a group personal pension that meets certain conditions:

- it must be available to all employees who should have access to a stakeholder pension scheme (except those under 18), and
- the employer must contribute an amount equal to at least 3 per cent of the employee's basic pay to the personal pension, and
- the employer must deduct the employee's contributions direct from their pay and send them to the personal pension provider if the employee asks them to.

Stakeholder schemes offered by employers

From October 2001 all employers with more than five employees must offer access to a stakeholder pension scheme, unless the employer:

- already offers its staff an occupational pension scheme that all can join within a year of starting work with that employer
- already offers a group personal pension scheme that meets the conditions mentioned left.

Group stakeholder pensions work in a similar way to group personal pension schemes, except the employer is not obliged to contribute to a stakeholder scheme. It is only obliged to offer access to one.

Employers don't have to provide access to a stakeholder pension for any employee:

- who has worked for the employer for less than three months in a row
- who is a member of the employer's occupational pension scheme
- who cannot join the occupational scheme because its rules don't admit people if they are under 18 or they are within five years of the scheme's normal pension age
- who could have joined the employer's occupational scheme but chose not to
- whose earnings have not reached the National Insurance lower earnings limit for at least three months in a row, or
- who cannot join a stakeholder pension scheme because of Inland Revenue restrictions (for example, the employee lives abroad),

CONTRIBUTION LIMITS

The table shows the maximum percentage of 'net relevant earnings' (NREs) you can pay in to a personal pension plan or stakeholder pension (right-hand column), or to a retirement annuity contract (middle column).

If you're self-employed, net relevant earnings are broadly taxable profits. If you're employed, they are employment earnings that don't carry pension rights (so you can't count income from an employer whose pension scheme you are in). With stakeholder pensions and PPPs, you can take account of only the first £95,400 of your net relevant earnings (in 2001-2002).

Age at start of tax year	Plan taken out before July 1988 (RAC)	Plan taken out in or after July 1988 (PPP)
up to 35	17.5%	17.5%
36 to 45	17.5%	20%
46 to 50	17.5%	25%
51 to 55	20%	30%
56 to 60	22.5%	35%
61 to 74	27.5%	40%
75 and over	nil	nil

There is also a 25 per cent limit on the proportion of a PPP or stakeholder fund that you can withdraw as a tax-free lump sum. With RACs, the maximum is instead three times the income from the remaining fund. Note that there's a £150,000 limit for plans taken out on or after 17 March 1987.

OTHER PENSION OPTIONS

Employers' schemes are nearly always the best sort of pension, especially if your employer is contributing. So you shouldn't normally take out a private pension if you are eligible to join an employer's scheme.

But if your employer doesn't run a scheme, or you're self-employed, you can choose to contribute to either a personal pension plan (PPP) or one of the new stakeholder pension plans (SPP).

How do PPPs and SPPs work?

Personal stakeholder pensions are simply personal pensions that meet certain conditions, such as low charges and flexible contributions.

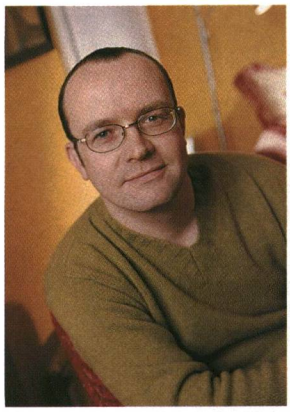
You pay contributions into these schemes over a period of time up to your chosen retirement date, at which time you use the fund to provide you with an income. You can take part of the fund as a tax-free lump sum.

STAKEHOLDER PENSIONS

To qualify as a stakeholder pension, the plan must meet certain conditions:

- charges can be levied only as a percentage of the pension fund (so no separate policy fees, penalties and so on). This makes comparison with other products easier
- the maximum charge is 1 per cent of the fund a year (with personal pension plans, 1.5 per cent is common). This will include the cost of providing information and basic advice. Providers will be allowed to charge extra for detailed advice
- there can be no charges for transfers in or out of a stakeholder scheme

Better off with a stakeholder



Anthony Langan is thinking of going freelance and is concerned that he hasn't got much of a pension built up so far. A new stakeholder pension will be perfect for Anthony as the costs are low and in the early days of being freelance he doesn't want to be tied down to a regular contribution. With a stakeholder pension there are no penalties for stopping and starting premiums so it has the flexibility Anthony needs.

From May 1999 to February 2000 Anthony contributed to a group personal pension scheme (GPP) run by his last employer and he was wondering whether he should transfer the value of his GPP to his new stakeholder. However, because of charges imposed under old-style policies, the transfer value of his GPP is currently under £300, even though the actual value of the fund is almost £2,000. Wisely, Anthony's going to leave his GPP where it is for the moment and concentrate on setting up his new stakeholder.

- they must generally accept transfers from other pension schemes
- the minimum contribution for regular or one-off payments must be no more than £20, and there must be no penalties for stopping and starting premiums.

A plan for all

The big change with stakeholders is that anyone can pay into one even if they have no taxable income (other than members of occupational schemes earning £30,000 or more or who are controlling directors). Up until now, only people with earnings could take out a pension plan and get tax relief on the premiums. You can even pay into a stakeholder on behalf of your children (but be warned – they can't get their hands on the money until they're 50 so they may not thank you for it).

Stakeholder or personal pension

Personal pension plans are still available, but the question remains as to who will be buying them.

Stakeholder pensions have all the advantages of personal pensions, but none of the disadvantages (such as penalties on transfer). As with personal pensions, you can draw your benefits at any time between 50 and 75, and you can take a tax-free cash sum of up to 25 per cent of your fund. You can contribute to as many stakeholder plans as you want, provided you don't exceed your contribution limit. The table on p28 shows the limits for stakeholders, personal pensions and old-style private pension plans – retirement annuity contracts (RACs). If you have no income, or a very low one, the limit is £3,600 gross for personal pensions and stakeholder pensions – but people with no earnings still can't contribute to RACs.

All in all, if you're looking for a new pension, stakeholder schemes will almost always be a better bet than old-style personal pensions. For more information on stakeholder pensions and what they mean to you, see 'Escape to stakeholder', *Which?*, March 2001, p21.

How you get tax relief

From April 2001, personal pensions and stakeholder pensions will have an integrated tax regime.

You can contribute up to £3,600 a year gross (you pay £2,808) irrespective of earnings, even if you have no income at all. For contributions over £3,600, the existing personal pension levels (see the table, p28) will be used to work out the maximum you can put in. Also, contributions over £3,600 can continue to be made for up to five years after your earnings have ceased.

Contributions to either a stakeholder or personal pension are made net of basic-rate tax (whether you're self-employed, employed, or have no earnings). So with basic-rate tax at 22 per cent, you pay only £78 for a £100 contribution. If you're a higher-rate taxpayer, you claim the extra relief via the tax return. Even if you pay no tax or tax at the starting rate, you still get the tax relief, effectively adding a bonus to your savings.

You can still get relief on life insurance via stakeholder pensions and PPPs. For a policy started on or after 6 April 2001 premiums must not exceed 10 per cent of the contributions paid by the individual and the employer. For a policy started before that date, a limit of 5 per cent of your net relevant earnings continues to apply.

Carry back

You can ask for all or part of the amount you pay to your private pension (a personal pension, stakeholder or retirement annuity contract) to be treated for tax purposes as if you'd paid it in the previous year (as long as you have sufficient unused relief in that year).

So, for example, a contribution made in the current tax year can be treated as though it was made in the tax year ending April 2001. Relief is given at the tax rate applicable in the earlier year.

In the case of a personal pension or stakeholder scheme, you have until 31 January following the year to which you want to carry back the contribution to opt to use the carry-back rule. The option must be made before or at the time you pay the contribution. For example, if you want to carry back a payment to 2000-2001 you must pay it and make the option by 31 January 2002.

The rules for retirement annuity contracts (RACs) are different. To carry back a contribution to 2000-2001 it must be paid by 5 April 2002 and you have until 31 January 2003 to decide whether or not to carry it back.

However, in the case of RACs, carry-back claims are allowed only once the tax for the earlier year has been calculated and paid. If you have an outstanding liability for that year, the relief you carry back is offset against it. If not, the Revenue repays the relief. Use Inland Revenue form PP43 to carry back contributions.

MORE HELP

INLAND REVENUE LEAFLET

IR78 Looking to the future

INLAND REVENUE HELPSHEET

IR330 Pension payments

FSA FACTSHEET

Stakeholder pensions and decision trees www.fsa.gov.uk

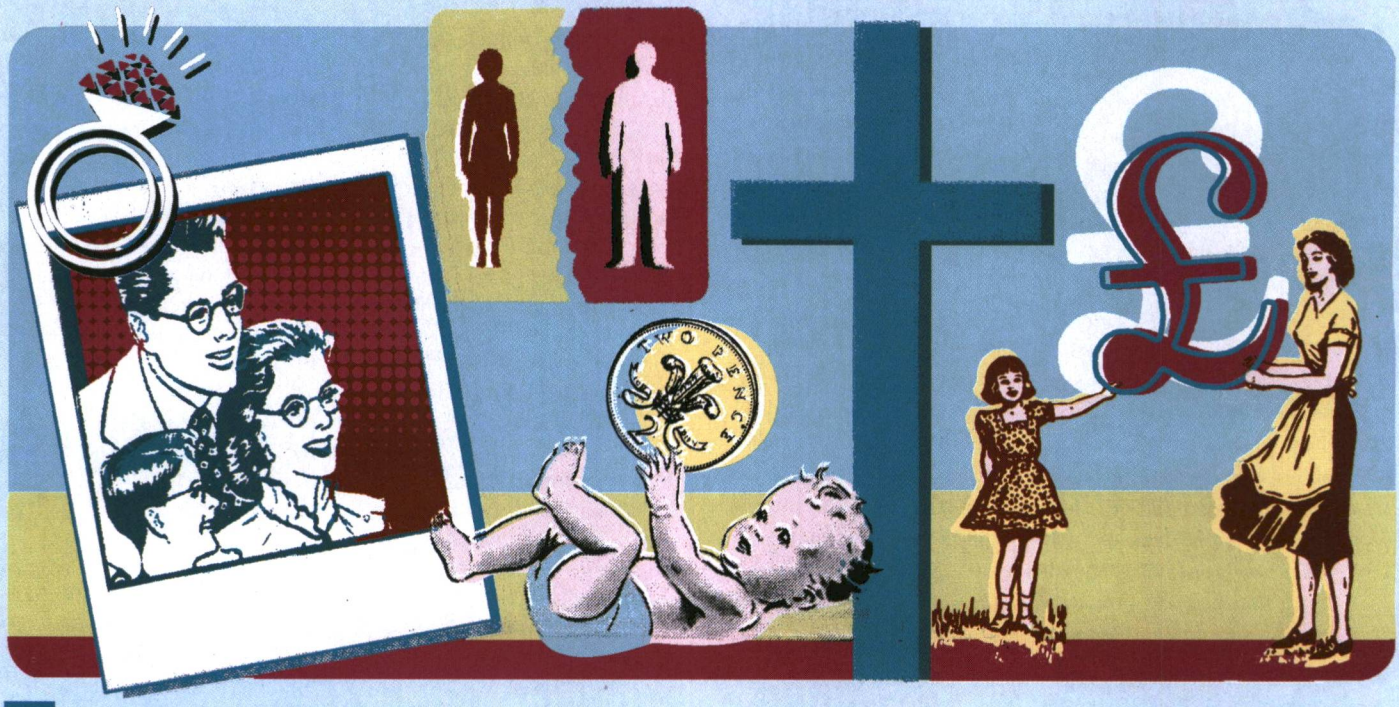
✆ 0800 917 3311 to order

DSS

Pensions information line

✆ 0845 7313233

YOU AND YOUR FAMILY



The recent budget was hailed as a budget for families, with the introduction of the children's tax credit and the increase in working families tax credit.

Whether you're married, cohabiting, divorced, widowed or have children, this chapter explains how the new tax rules will affect you.

TAX AND MARRIAGE

Husbands and wives are taxed independently. This means each have their own personal allowance (the amount you can earn before you start paying tax). For the 2001-2002 tax year, this allowance is £4,535. If you don't use up all of your allowance, you can't transfer this to your husband or wife.

Up until April 2000, all married couples could claim the married couple's allowance. The relief was given as a deduction from other tax you owed. But since 6 April 2000, most married couples are no longer eligible to claim this allowance. You can claim it only if you, or your husband or wife, were born before 6 April 1935. For more information, see p16.

Joint income

If you and your spouse have investments in joint names (shares, for example), any income is initially treated as if it were received in equal shares: you each pay tax on half. If you own the investments in unequal shares, the income can be taxed the same way if you complete form 17 (available from your tax office).

If one spouse pays tax at the higher rate, and the other doesn't, or one spouse is a non-taxpayer, it makes sense to transfer income-paying investments to the person paying the least tax. This saves tax as long as the transfer is genuine (for example, the investment must be transferred into your spouse's name).

If you are bereaved

From April 2001 there are three new benefits that you may be entitled to if your husband or wife dies. These new benefits replace widow's allowance, widowed mother's allowance and widow's pension. However, if you are already receiving widowed mother's allowance or widow's pension, the changes won't affect you. You will carry on getting these weekly benefits for as long as you meet the existing criteria. To claim the new benefits you must have been legally married – you won't be entitled to claim if you were divorced from or cohabiting with your late partner. Also, to be eligible, your late husband or wife must have either paid National Insurance contributions (your own don't count), or his or her death was caused by their job. The biggest change is that the new benefits are available to both widows and widowers. Previously, only women were eligible for bereavement benefits.

Bereavement payment

This is a tax-free payment of £2,000 paid to you as soon as you are widowed. However, it's only payable if your late husband or wife was not entitled to the state retirement pension when he or

WIDOW'S BEREAVEMENT ALLOWANCE

This was a tax allowance given to widows in the year of their husband's death and for the year after that, provided they didn't remarry. However, this allowance was abolished in the March 1999 budget.

If your husband died between 6 April 1999 and 5 April 2000, you were entitled to claim the allowance for the 1999-2000 and 2000-2001 tax years. If you didn't claim the allowance you can still do so – see our table on missed allowances on p32.

she died or you were under state pension age when your husband or wife died. Those in receipt of state pension are not entitled to this payment.

Widowed parent's allowance
This is a taxable weekly benefit worth the same as the widowed mother's allowance. It includes:

- a basic allowance for you
- an allowance for each of your dependent children and
- additional pension (state earnings related pension) if you qualify.

You will be eligible for widowed parent's allowance if you have a child that qualifies for child benefit or you are a woman expecting your late husband's baby. If you are a widower whose wife died before the introduction of widowed parent's allowance, you can still claim the allowance when it's introduced, provided you meet the entitlement conditions.

Bereavement allowance
This is a taxable weekly benefit paid for 52 weeks after your husband or wife dies, to people aged 45 or over. This replaces widow's pension. You won't get bereavement allowance if you are entitled to widowed parent's allowance.

Married couple's allowance
If your husband dies, and if you're still eligible for the married couple's allowance, it is given to your husband in the year of his death, even if you and your husband shared the allowance. You can claim any unused part, after it has first been set against your husband's tax liability for the year of his death.

If your wife dies, you can continue to receive the married couple's allowance for the whole of the tax year during which your wife dies. If part or all of the allowance had been allocated to your wife, you can have any unused part transferred to you.

MORE HELP

INLAND REVENUE LEAFLETS

IR45 Tax when someone dies
IR115 Tax and childcare

HELPLINES

National Council for One Parent Families ✆ 08000 185 026
Citizens' Advice Bureaux see phone book
Federation of Independent Advice Centres ✆ 020 7489 1800
Inland Revenue children's tax credit helpline ✆ 0845 300 1036
Inland Revenue working families tax credit helpline ✆ 0845 609 5000

Other taxes
There are special rules for married couples when it come to capital gains tax (CGT) and inheritance tax (IHT).

There's normally no CGT to pay at the time a gift or transfer is made between spouses. This doesn't apply if you're divorced or separated (except in the tax year of separation), or to unmarried partners.

A husband and wife can give unlimited amounts of money or possessions to each other without being liable for IHT unless the recipient's domicile (broadly, their permanent home) is outside the UK, when there is a £55,000 limit. Once divorced, this exemption is lost but there's still no inheritance tax to pay on:

- money paid as a divorce settlement
- maintenance payments to a former partner or children, including adopted and step-children, who are under 18 or in full-time education
- in some cases, money given to you following a change to an agreement you made on or before your divorce.

LIVING TOGETHER

If you live together as an unmarried couple, your income tax position is much the same as if you were married. However, there are some differences. You won't be entitled to the married couple's allowance (even if you or your partner were born before 6 April 1935), nor are you entitled to the CGT and IHT concessions mentioned left.

Also, if you are unmarried and your partner dies, you can't claim any of the bereavement benefits paid to widows or widowers, (see 'If you are bereaved', opposite).

Unmarried with children
Before 6 April 2000, unmarried parents living with a child could claim an allowance called the additional personal allowance. Like the married couple's allowance, this was given as a deduction from your tax bill, but it was abolished from 6 April 2000. However, a new children's tax credit that you can claim (see below) replaced this from April 2001.

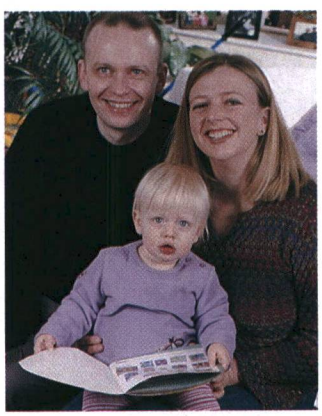
If you were eligible for the additional personal allowance at any time from 6 April 1996 to 5 April 2000, but didn't claim it, you can do so now – see our table on missed allowances, p32.

TAX AND CHILDREN

A new tax allowance, called the children's tax credit, was introduced from 6 April 2001. It's available to all parents with one or more children under 16 living with them.

Despite its name, this doesn't work like the working families tax credit (see p20). Instead, a percentage of the allowance (10 per cent) is given as a deduction against your tax bill in the same way as the married couple's and additional personal allowance did. In 2001-2002 the allowance will be £5,200, so the tax bill of

Taking the credit



Shauna and Phillip are eligible to claim the new children's tax credit (CTC) for their daughter, Maya, aged 18 months. They're both basic-rate taxpayers. However, as Phillip is self-employed, they have decided Shauna should claim the credit as all her earnings are paid through PAYE and they'll get the benefit of paying less tax immediately. Shauna has filled in form CTC1 and sent this to her tax office. She's now waiting to receive a new PAYE code which will reduce the amount of tax she pays by £520 this tax year. Some people who filled out their forms early will have received coding notices for the 2001-2002 tax year, showing tax codes based on the pre-budget level of CTC (£4,420). Because CTC was increased in the March 2001 budget to £5,200, these people's tax codes should have changed again to reflect the higher amount of CTC, backdated to April. If you were one of the people affected, you won't necessarily have received another coding notice. Instead, your tax office should have notified your employer direct of the new code.

eligible families will be reduced by £520.

If neither parent is a higher-rate taxpayer then you can choose which parent claims the credit, or even have it split between you. However, if one parent is a higher-rate taxpayer, the allowance must be claimed by them. This is because the credit is gradually withdrawn at the rate of £1 of credit for every £15 of income taxed at the higher rate. As a rough guide, if one of you earns over £41,000 it is unlikely you will receive any children's tax credit. From April 2002, CTC will be doubled for the first year of a child's birth.

To claim children's tax credit you need to complete form CTC1 available from your tax office or from the special Inland Revenue helpline set up to provide information on the children's tax credit. The number is 0845 3001036.

Childcare payments

If your employer provides a crèche that you're eligible to use, this benefit isn't taxable. However, if you receive childcare vouchers, the value of these is added to your salary and taxed as income. There is a small benefit to receiving vouchers, which is that they aren't counted as income when working out how much National Insurance you pay.

SEPARATION AND DIVORCE

Up until 6 April 2000, the tax rules that dealt with the break-up of a marriage were complex. However, the March 1999 budget changed all that. There is now no tax relief on maintenance payments unless you or your ex-partner were born before 6 April 1935. If you are still eligible to claim maintenance relief, you receive a reduction in your tax bill as you do with married couple's allowance or children's tax credit. The amount deducted is equivalent to 10 per cent of either the maintenance you pay or £2,070 (this year's maintenance allowance), whichever is lower. The rules for receiving maintenance are also simpler. Payments you receive under a maintenance agreement are now treated as tax-free income regardless of whether they are from an ex-spouse, parent or step-parent.

CLAIMING MISSED ALLOWANCES

If you don't claim an allowance, you have six tax years (before the current year) to reclaim it – until 6 April 2002 for allowances from 1995-1996. The amount of the allowance is shown in the table; where relief is restricted, the second column shows what the allowance is worth.

Unrestricted allowances

The full amount of personal and blind person's allowances is deducted from your income before working out tax.

Personal This is the amount you can earn each year before you pay tax. It's unlikely you won't receive it. But if you're 65 or older, you could claim a higher age-related amount.

Blind person's In England and Wales, you must be registered as blind on a local authority register to claim this allowance. There's no register in Scotland or Northern Ireland – you qualify if you can't perform any work for which eyesight is essential. If you are eligible for the allowance, but don't earn enough to use it up, you can transfer any surplus to your spouse.

Restricted allowances

These were abolished for most people from 6 April 2000. Relief is limited to a fixed percentage of the allowance. Employees received the relief by an adjustment to their PAYE code. From 1995-1996 until 1998-1999 relief was 15 per cent; it was cut to 10 per cent in 1999-2000. The table shows the amount of each allowance and what it was worth. In 1995-1996, for example, basic married couple's allowance was worth £258 (£1,720 x 15 per cent).

Married couple's This was given to married couples (only a proportion in the year they marry if the wedding is after 5 May). Higher amounts were (and still are) available to older people.

Additional personal You could claim this if you had a child in full-time education or under 16 (at the start of the tax year) who lived with you for all or part of the year, and you were single, cohabiting, widowed, divorced, or separated. You could also claim this, in addition to married couple's allowance, if you were married and your husband or wife was incapacitated through illness or disability throughout the tax year. This double allowance used to be available only to men with wives who were incapacitated, but women with incapacitated husbands could also claim it from 6 April 1997.

Widow's bereavement You could claim this in the tax year of your husband's death and the following one, unless you remarried before the start of the tax year.

Maintenance relief This was available to some people who were paying enforceable maintenance payments.

	1995-1996 (£)		1996-1997 (£)		1997-1998 (£)		1998-1999 (£)		1999-2000 (£)		2000-2001 (£)	
	Amount	Worth	Amount	Worth	Amount	Worth	Amount	Worth	Amount	Worth	Amount	Worth
Unrestricted												
Personal	3,525		3,765		4,045		4,195		4,335		4,385	
Age-related personal (65 to 74)	4,630		4,910		5,220		5,410		5,720		5,790	
Higher age-related personal (75 or over)	4,800		5,090		5,400		5,600		5,980		6,050	
Blind person's	1,200		1,250		1,280		1,330		1,380		1,400	
Restricted												
Basic married couple's	1,720	258	1,790	269	1,830	275	1,900	285	1,970	197	2,000[1]	200
Higher married couple's (65 to 74)	2,995	449	3,115	467	3,185	478	3,305	496	5,125	513	5,185[1]	518
Higher married couple's (75 or over)	3,035	455	3,155	473	3,225	484	3,345	502	5,195	520	5,255	525
Additional personal	1,720	258	1,790	269	1,830	275	1,900	285	1,970	197		
Widow's bereavement	1,720	258	1,790	269	1,830	275	1,900	285	1,970	197	2,000[2]	200
Maintenance relief	1,720	258	1,790	269	1,830	275	1,900	285	1,970	197	2,000[3]	200

1 Available only if you or your husband or wife were born before 6 April 1935
2 Available only if you claimed widow's bereavement allowance in 1999-2000
3 Available only if you or your ex-spouse was born before 6 April 1935

GIFTS AND BEQUESTS

Planning ahead can help reduce the tax you pay when you pass on money or property as a gift or legacy – to your family, for example.

There are two types of tax that you usually need to consider when you make a gift:

- Capital gains tax (CGT). There's no CGT on cash gifts, or on anything you leave when you die. But if you give away an asset such as a painting, you may have to pay CGT if the value of the asset has increased during the time you owned it (see p24).
- Inheritance tax (IHT). Most gifts that you make while you're alive currently escape IHT. But if you die within seven years of making the gift, the recipients could face a bill. The tax that's payable, and who pays it, depends on what the gift is, and whether you make it during your life, or via your will after your death.

TAX-FREE GIFTS

The following gifts are always free of both CGT and IHT whether they are made during your lifetime or as a bequest in your will when you die:

- gifts between a husband and wife who are both domiciled in the UK at the time of the gift. For CGT purposes, the couple must live together for some of the tax year
- gifts to UK-established charities
- gifts to national art galleries, universities, local authorities and other similar bodies
- gifts of UK land to registered housing associations
- broadly, gifts of shares to a trust that holds over half a company's shares, that was set up for the employees' benefit, and over which the trustees have voting control.

IHT-EXEMPT GIFTS

The following gifts, which you might make during your lifetime, are always free of IHT. However, if the gift is an asset, rather than cash, there may be some CGT to pay:

- gifts to people getting married, with a maximum value of £5,000 from each parent of the couple, £2,500 from each grandparent, and £1,000 from anyone else
- gifts worth up to £250 a year to each recipient
- maintenance paid to ex-spouses and transfers of property as part of a divorce settlement
- gifts up to any amount that are part of your normal expenditure (such as premiums on a life insurance policy for someone else's benefit), provided they don't reduce your standard of living
- gifts of reasonable amounts to support a dependent relative
- gifts for the education, maintenance or training of your children if they are still in full-time education or training, or aged 18 or below
- gifts to political parties represented in Parliament. Such gifts can also be made on death and are then free of CGT (as well as IHT).

Each tax year, annual gifts up to £3,000 not covered by the list above are free of inheritance tax. Spouses each have their own £3,000 limit. If you don't use up the limit, you can carry it forward one year only to the next tax year and give up to £6,000.

MORE HELP

INLAND REVENUE LEAFLETS

IR45 What to do about tax when someone dies
IR65 Giving to charity
IR152 Trusts
IHT2 Inheritance tax on lifetime gifts
IHT3 Inheritance tax – an introduction
IHT15 Inheritance tax – how to calculate the liability

INLAND REVENUE HELPSHEETS

IR282 Death, personal representatives and legatees
IR295 Relief for gifts and similar transactions

LIFETIME GIFTS AND IHT

Gifts that are taxable for IHT when you make them are mainly gifts to companies and to the trustees of certain types of trust where no specific beneficiary has a right to income. These are known as discretionary trusts.

Even then, IHT is due on the gift only if the sum of your taxable (also known as chargeable) gifts over the seven years up to the time of the latest gift (your running total) comes to more than the tax-free IHT allowance (£242,000 from 6 April 2001). If IHT is payable on lifetime gifts, it's charged at half the rate charged at death (so currently at 20 per cent). If you die within seven years of making the gift, tax is reassessed at the then death rates (currently 40 per cent) and extra tax may be payable.

POTENTIALLY EXEMPT TRANSFERS

Most gifts or transfers made during your lifetime, other than those already mentioned, are treated as potentially exempt transfers (Pets). No IHT is payable when you make the gift, but if you die within seven years of making it, the gift is included in the IHT calculations.

On your death, all Pets and other taxable lifetime gifts you made in the previous seven years are treated as part of your estate and applied in chronological order to the tax-free IHT allowance. Although this means that often no IHT is paid on past ▶

TAPER RELIEF

Time from gift to death	Reduction in tax payable on Pet (%)
0 to 3 years	nil
3 to 4 years	20
4 to 5 years	40
5 to 6 years	60
6 to 7 years	80

gifts, it does mean that some or all of the tax-free slice is used up, leaving little or no relief for the rest of the estate. If tax does become payable on a Pet, it is levied at the rate applicable at death (currently 40 per cent). However, if a Pet does attract tax, it may be reduced depending on the length of time from making the gift to death. This is called taper relief, as shown in the table above. Taper relief applies only to the extra tax due on the Pet (see example below).

PAYING TAX

The giver pays any CGT on gifts made during their lifetime. Liability for IHT depends on when the gift is made. If it's taxable at the time the gift is made, either the giver or the recipient can pay the IHT. If the giver pays, the total gift is assumed to be the value of the gift plus the tax. If the giver fails to pay the tax, the Revenue may be able to recover it from the recipient. If tax becomes due because the giver has died within seven years of making the gift, it is charged initially to the person who received the gift. If they can't or won't pay, the giver's estate must pay the bill.

GIVING AWAY A BUSINESS

You may qualify for hold-over relief from CGT when you give away business assets, including certain unlisted shares in trading companies. This means that there is no tax to pay at the time of the gift, and any increase in the value of the asset after it is given away will be taken into account only when the recipient sells on the assets. If retirement relief applies (see 'CGT and business' p26), this takes precedence.

Most gifts of business assets qualify for business property relief from IHT. So, in most cases, no IHT (or a reduced amount) will be payable.

TAX ON YOUR DEATH

There is no CGT on assets that you leave when you die, but your estate may have to pay IHT depending on how much you leave. To value your estate, add up:

- any gifts you made in the last seven years which are not exempt from IHT (basically Pets you have made and any chargeable lifetime gifts)
- your property (include any you own abroad), cash, savings and investments and life insurance paid to your estate
- income/property you are entitled to under the terms of some trusts
- any gift you still continue to benefit from (for example, a house you have given to your children which you continue to live in). This is known as a 'gift with reservation' and for IHT purposes it is as though the gift was never made.

After that, subtract:

- gifts in your will that are exempt from inheritance tax (to a surviving spouse, for example)
- your debts (such as a mortgage) and reasonable funeral expenses.

If the total value of your remaining estate is no more than the tax-free slice, there is no IHT liability. If it is valued above this, the excess will be taxed at 40 per cent on death.

TAX ON BEQUESTS

You can specify in your will that a bequest is to 'bear its own tax' – this means that the person receiving the gift pays any tax due; otherwise, the estate has to pay the IHT. If it is a cash gift, the recipient receives the net sum.

REDUCING IHT

You can't avoid IHT by giving something away if you continue to benefit from it. This will be a gift with reservation and still count as part of your estate. However, there are steps you can take to reduce the amount of IHT payable when you die.

Start making gifts early: gifts to individuals made at least seven years before your death are free of tax (although there may be CGT to pay if you give away assets rather than cash). You can also use your gift allowances – some gifts made in your lifetime are tax free even if you die within seven years of making the gift.

Use your will for tax planning. From 6 April 2001, each person can give up to £242,000 without paying IHT. Married couples together have an allowance of £484,000. However, unless a person's allowance is used during their lifetime, on their death, or by a deed of variation (which alters the terms of the will) within two years of death, it will be lost, as it cannot be transferred to the surviving partner.

For example, most couples own assets under a joint tenancy. This means that on the death of one partner, the asset passes automatically to the surviving owner, despite what the will may say. This can ruin careful IHT planning. It's possible to hold assets under a tenancy in common, where each person owns part of the asset separately and can decide who their portion is left to. See a solicitor about this.

In addition, by making some simple adjustments to your will, so that part of your estate passes on your death to the next generation rather than wholly to your spouse, you will substantially reduce the IHT bill when both you and your spouse have died – in fact, you could end up reducing it until there is no IHT at all to pay.

THE EFFECT OF TAPER RELIEF ON IHT

A man gives each of his five children a Christmas gift of £15,000 between 1994 and 1998 (£75,000 a year). He dies on 30 April 2001. This is how the gifts are treated for IHT on his death, assuming he's used his £3,000 gift exemption each year, and that none of the gifts qualified for the exemption for normal expenditure out of income.

Date of gift	Running total	Tax payable	Reason
25 Dec 1994	£75,000	nil	Gifts within tax-free slice of £242,000
25 Dec 1995	£150,000	nil	Gift within tax-free slice of £242,000
25 Dec 1996	£225,000	nil	Gift within tax-free slice of £242,000
25 Dec 1997	£300,000	£18,560	£17,000 is within £242,000 tax-free slice. The remaining £58,000 is subject to IHT but the tax is reduced by 20 per cent (see the taper relief table, above)
25 Dec 1998	£375,000	£30,000	All the gift is subject to IHT with no reductions. The remaining estate is also subject to IHT at the full 40 per cent, as all the tax-free slice has been used up on Pets made within the seven years before death

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KEY

TRG *Which? Tax Return Guide 2001* (published in April)

TSG *Which? Tax Saving Guide 2001*

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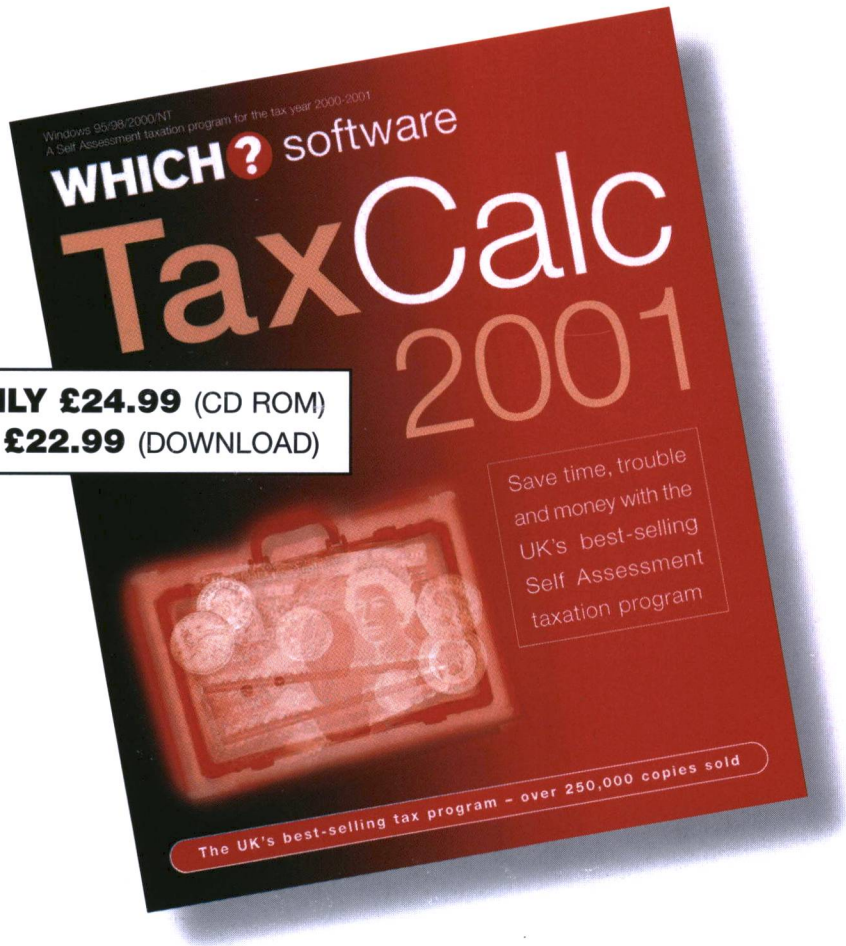
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